S. HRG. 100-112

NOMINATION OF M. PETER McPHERSON

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

NOMINATION OF

M. PETER McPHERSON TO BE DEPUTY SECRETARY OF THE TREASURY

MAY 20, 1987

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NOMINATION OF M. PETER McPHERSON TO BE DEPUTY SECRETARY OF THE TREASURY

WEDNESDAY, MAY 20, 1987

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee was convened, pursuant to notice, at 10:08 a.m. in Room SD-215, Dirksen Senate Office Building, the Honorable Lloyd Bentsen (chairman) presiding.

Present: Senators Bentsen, Moynihan, Rockefeller, Daschle, Packwood, Chafee, Heinz, Wallop, and Durenberger.

[The press release announcing the hearing and a biographical sketch of Melville Peter McPherson follows:]

[Press release]

COMMITTEE ON FINANCE ANNOUNCES HEARING TO REVIEW NOMINATION OF M. PETER MCPHERSON

Washington, DC.—Senator Lloyd Bentsen (D., Tex.), Chairman, announced Thursday that the Committee will hold a hearing to review the nomination of M. Peter McPherson to be Deputy Secretary of the Treasury.

Mr. McPherson currently serves in the capacity of Administrator of the Agency for International Development.

The hearing will be held on Wednesday, May 20, 1987 at 10:00 A.M. in Room SD-215 of the Dirksen Senate Office Building.

United States
Office of Government Ethics
P.O. Box 14108
Washington, D.C. 20044

MAY 13 1987

Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by Melville Peter McPherson, who has been nominated by President Reagan for the position of Deputy Secretary of the Treasury.

We have reviewed the report and have also obtained advice from the Department of the Treasury concerning any possible conflict in light of its functions and the nominee's proposed duties. Based thereon, we believe that Mr. McPherson is in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

David H. Martin
Director

Enclosure

A. BIOGRAPHICAL:

1. Name: Melville Peter McPherson

2. Address: 2800 N. Fairfax Dr. No. 403
Arlington, VA 22203

3. Date and Place of Birth: October 27, 1940
Grand Rapids, Michigan

4. Marital Status: Divorced

5. Names and ages of Children: Michael David Kircher-22-step-son
Donald Bruce McPherson-16-

6. Education: Michigan State University, Graduated 1963
B.A. - Political Science

Western Michigan University, Graduated 196
M.B.A.

American University Law School, Graduated 1969 - J.D.

7. Employment Record:

1964-1966 - Peace Corps

June, 1969-March, 1975 - Internal Revenue Service, Tax Law Specialist, Corporation Branch specializing in international and corporate tax matters in the national office.

March, 1975 - January, 1977 - White House, Associate Director of Presidential Personnel Office, and then Deputy Director of Presidential Personnel and Special Assistant to President Ford.

During the Summer and again in the Fall of 1976 - I left the White House to work on President Ford's campaign.

January, 1977 - January, 1981 - Vorys, Sater, Seymour & Pease Law Firm. Partner and head of Washington office.

1979-1980 - Part time effort as Regional Campaign Director for Ronald Reagan campaign.

November 6, 1980 - January 21, 1981 - General Counsel to Reagan-Bush transition

January 21, 1981 - February 20, 1981 - Acting Legal Counsel to the President, White House

March 5, 1981 - present - Administrator, Agency for International Development.

8. Government Experience:

1958 - Page, Michigan House of Representatives

Summer of 1963 - Property Tax Assessor's Office, Lansing, Michigan

1964-1965 - Peace Corps

1969-1975 - Internal Revenue Service

1975-1977 - White House - Associate Director of Presidential Personnel Office and then Deputy Director, Presidential Personnel Office and Special Assistant to the President

1980 Initial Trustee to Presidential Transition Trust

1977-1980 - Member of Presidentially appointed and part time Board for International Food and Agricultural Development (BIFAD).

1981-present - Chairman, Overseas Private Investment Corporation (OPIC) Board of Directors

1981-present - Member of the Board of Inter-American Foundation (IAF)

9. Memberships:

1973-present	Board member of American Council of Young Political Leaders
1980-present	Board member of Jobs for American Graduates
1972-present	American Bar Association (also Michigan and D.C. bars)

10. Political affiliations and activities:

1977-1980	Parliamentarian - Maryland Republican party
1979-1980	A Regional Political Director - Reagan campaign
1980	Work to plan Reagan transition

Note: Several financial contributions to candidates and parties. No contribution more than $200.00 and most much less. No more than $300.00 per year and usually much less.

11. Honors and Awards

1987 - Certificate of Special Merit
U.S. Dept of State
U.S. Dept of Housing & Urban Development
The UN International Year of Shelter for the Homeless (IYSH)

1987 - Plaque, In appreciation for leadership on the Board of Directors of Jobs for America's Graduates, Jan. 87.

1986 - Honorary Doctorate of Humane Letters from Mount St. Mary's College.

1986 - Plaque, InterAction Board of Directors during African Famine Emergency and strong support of PVOs, Nov 6, 1986.

1985 - Outstanding Humanitarian Award
The Young Republican National Federation, March 23, 1985

1985 - Cooperative League of the United States of America in recognition of his innovative leadership and effective support of the Cooperative Business Development Around the World, April 30, 1985.

1985 - Commendation from Agricultural Cooperative Development International and National Council of Farmer Cooperatives.

1985 - Recognition Award from the International Institute for Infant Nutrition and Gastrointestinal Disease, Children's Hospital of Buffalo.

1985 - Certificate, in appreciation for the Prevention of Famine and Freedom from Hunger from the Commission on International Agricultural Programs of the National Association of State Universities and Land-Grant Colleges.

1985 - Copernicus Society Award involved gift of $10,000. Could not accept it under law because job related and it was given to International oriented non-profit organization.

11. Honors and Awards - Continued:

1984 - Honorary Doctorate of Law from Michigan State University.

1984 - Honorary Doctorate of Humane Letters from Virginia State University.

1983 - Resolution Honoring Leadership as a Member of the Board for International Agricultural Development and as Administrator of A.I.D. from National Association of State Universities and Land-Grant Colleges, Nov. 13, 1983.

1983 - "Humanitarian of the Year" Award from the American Lebanese League.

1981 - Certificate of Appreciation for Outstanding Public Service from Board for International Food and Agricultural Development (BIFAD).

NO DATE

Plaque - Of Appreciation in providing home ownership opportunities for poor people in developing countries:
Cooperative Housing Foundation
National Association of Realtors
National Housing Conference
National Association of Housing and Redevelopment Officials
U.S. League of Savings Institutions
National Association of Housing Cooperatives
National Cooperative Bank
National Association of Home Builders
Housing Assistance Council
National Council of Savings Institutions

12. Published Writings:

1. "War Will Not Leave the Hungry Alone", Washington Post, March 5, 1985.

2. "U.S. Affirms Strong Aid for Africa", USIA, Worldnet, April 10, 1984.

3. "We Weren't Looking for a Quick Fix", The New York Times, November 23, 1986.

4. Statement on issuance of the World Development Report, 1983, July 24, 1983.

5. "Food for Hungry 'Without Regard to Politics'", U.S. News & World Report, May 13, 1985.

6. "Helping Grenada Rebuild", The Washington Times, November 6, 1984.

7. "What's Gone Right-and Wrong-With Aid", U.S. News & World Report, November 17, 1986.

8. "AID Administrator Remembers", Peace Corps Times, 1987.

9. "Helping the Hungry - Saving the Children is a Battle We Can Win", USA Today, January 14, 1986.

10. "India's Strides in Development Highly Impressive; Innovative U.S. AID Activities Helping Millions", Indo-American Business Times, February, 1987.

11. Booker and McPherson, "Ford-Canton: The Struggle Continues", 17 LABOR LAW JOURNAL 538 (1967).

12. Booker and McPherson, "Unemployment Compensation and Labor Dispute Disqualifications", 21 LABOR LAW JOURNAL 247 (1969)

13. Possibly other writings we were not able to find at this time - all related to my A.I.D. position.

13. Speeches:

1987:

1. "Just Give Me the Opportunity" John A. Hannah International Lecture, Michigan State University, February 23, 1987.

2. Remarks given to the 1987 Southern Africa Development Coordination Conference, February 5, 1987, Gaborone, Botswana.

3. Declaration of U.S. Assistance to the SADCC Region, 1987 Southern Africa Development Coordination Conference, February 6, 1987, Gaborone, Botswana.

4. "Family Planning and the Private Sector", The Annual Conference of Cooperating Agencies, Westpark Hotel, Rosslyn, Virginia, January 21, 1987.

1986:

1. "Africa: An End to Famine", Minneapolis World Affairs Council, and Notre Dame University, January 28-29, 1986.

2. "Foreign Economic Aid: America's Investment in Peace", Humphrey Institute, University of Minnesota, January 28, 1986.

3. Keynote Address at the International Conference on Privatization, Washington, D.C., February 17, 1986.

4. "U.S. Foreign Policy on Water Resources in the Middle East and Horn of Africa", Center for Strategic and International Studies, Washington, D.C., February 20, 1986.

5. "Social Policy in the Middle East", Brandeis University's Center for Social Policy in the Middle East", Rayburn House Office Building, May 5, 1986.

6. Informal Remarks on "Foreign Economic Aid: America's Investment in Peace", Chamber of Commerce, Des Moines, Iowa, May 9, 1986.

7. Informal Remarks on "Foreign Economic Aid: America's Investment in Peace", World Affairs Council in Columbus, Ohio, May 6, 1986.

8. "Development: The New Name for Peace", Mt. St. Mary's College, Emmitsburg, Maryland, May 18, 1986.

9. "Lessons Learned from the African Drought", Committee on Food Aid, Rome, Italy, May 26, 1986.

13. Speeches - Continued:

10. Remarks before the United National General Assembly Session on the Critical Economic Situation in Africa, New York, New York, June 1, 1986.

11. Speech before the UNDP Governing Council, Geneva, Switzerland, June 9, 1986.

12. Remarks before the Interregional Conference on Health, Population, and Nutrition Programs, June 16, 1986.

13. Opening Session Welcome to the Conference on Tax Reform and Private Sector Growth, Washington, D.C., July 10, 1986.

14. Remarks before the Model Projects Awards Ceremony, Department of Housing and Urban Development, Washington, D.C., October 6, 1986.

15. Remarks to the InterAction Annual Board Meeting, Riverside Church, New York, November 5, 1986.

16. Remarks at the National Press Club, Washington, D.C. November 12, 1986.

17. Remarks at the City Club of Cleveland, Cleveland, Ohio, December 10, 1986.

18. Remarks before the Chicago Council on Foreign Relations, Chicago, Illinois, December 10, 1986.

1985

1. Speech before the Iowa Pork Producers Association, Des Moines, Iowa, January 23, 1985.

2. Speech before The Cosmos Club, Washington, D.C., January 28, 1985.

3. "Scholarship Diplomacy", Meridian House International, Washington, D.C., February 12, 1985.

4. "Tradenet Topics", Washington, D.C., February 26, 1985.

5. Opening Address at the Conference on "The International Role of Extension: Future Directions", Michigan State University, March 31, 1985.

6. "Prescription for a Health Revolution", Washington, D.C. April 4, 1985.

13. Speeches - Continued:

7. Address to Protestant Clergy & Laity, "The Moral and Ethical Dimensions of A.I.D. Policy", Washington, D.C., April 18, 1985.

8. "State of the Agency", Washington, D.C., April 23, 1985.

9. ACDI Breakfast Talking Points, Washington, D.C., April 24, 1985.

10. Association for Women in Development Conference, "Women Creating Wealth: Transforming Economic Development", The Capital Hilton, Washington, D.C., April 25, 1985.

11. Address to the Lowell, Michigan Rotary Club, Lowell, Michigan, April 26, 1985.

12. Statement made to the UNDP Governing Council, New York, New York, June 11, 1985.

13. "Perspectives in Development", Washington, D.C., May 6, 1985.

14. Talking Points to the U.S./China Joint Economic Committee, Washington, D.C., July 1985.

15. Speech before the National Resource Council Seminar, Washington, D.C., September 20, 1985.

16. "Drought in Africa: The Continuing Crisis and the Black American Response", Washington, D.C., September 26, 1985.

17. Remarks before the Pan American Health Organization Directing Council, Washington, D.C., September 27, 1985.

18. Address before the International Cooperative Alliance, New York, October 16, 1985.

19. Remarks before the Newsmakers Breakfast, International Symposium on Drought and Desertification, Howard University, October 26, 1985.

20. Remarks at the Inauguration Ceremonies of the International Institute of Infant Nutrition, Buffalo, New York, October 28, 1985.

21. Remarks at the Park East Synagogue, New York, November 4, 1985.

13. Speeches - Continued

22. "International Family Planning: The Reasons for the Program", American Enterprise Institute, November 25, 1985.

23. Opening Address and Closing Remarks at the Second International Conference on Oral Rehydration Therapy (ICORT II), Hyatt Regency Hotel, Washington, D.C., December 10, 1985.

24. Remarks at the PVO Award Ceremony, National Council for International Health, Washington, D.C., December 16, 1985.

25. Remarks at the Overseas Development Network Conference, Harvard University, Boston, Massachusetts, December 11, 1985.

Other remarks from time to time.

14. Qualifications:

I feel I am qualified to serve as Deputy Secretary of Treasury.

At A.I.D. for six years I have worked with the problems of some 70 countries that receive U.S.G. assistance and have a very good understanding of the economic problems of the developing world. A major change I have undertaken at A.I.D. is an emphasis on market-oriented economic reforms in countries in which A.I.D. works. In that context, I worked extensively on the economic policy issues of all major A.I.D. recipient countries from Egypt to Costa Rica. Obviously, I have been very interested and involved in the debt issues affecting A.I.D. recipients, e.g., the Philippines, Ecuador, several countries in Africa, etc. There are clearly differences between these situations and the large Latin debtor countries but there are many similarities. At A.I.D. I have followed closely the U.S. agriculture situation because that so affected the cost and type of commodities available through the PL 480 program administered by A.I.D. Also, Secretary Shultz has involved me extensively with a broad range of economic issues touching upon LDCs.

As a lawyer running the Washington office of a large Ohio law firm and at the IRS, I worked extensively with corporate and tax matters. This knowledge will clearly be of great help in the Treasury job.

My role in the Reagan-Bush Transition, as Acting Counsel for President Reagan for a short time and at the Ford White House has given me a government wide perspective that should serve me in good stead at Treasury.

At A.I.D. and previously, I worked extensively with Congress and take pride in my very many good relationships on the Hill. Clearly this is an integral part of any senior position in this government and certainly should be helpful at Treasury.

I am very interested in the economic issues at Treasury and would very much like to serve as Deputy Secretary at Treasury.

The CHAIRMAN. This hearing will come to order.

This hearing has been called this morning to provide the committee with information on the nomination of Mr. Peter McPherson to be Deputy Secretary of the Treasury.

In this role, he will be operating as the right-hand man of the Secretary and would be overseeing some very important functions carried on by the Department of the Treasury in the areas of tax policy, the public debt, and domestic and international financial markets.

He currently serves as the Administrator at the Agency for International Development. He is a lawyer with several years of tax experience, practicing tax law, both for the Internal Revenue Service and with a private law firm.

Mr. McPherson, we certainly welcome you to the committee.

I would like to defer to my colleague, Senator Packwood, for any comments he might have at this point.

Senator PACKWOOD. I have no comments, Mr. Chairman. I will have some questions.

The CHAIRMAN. Mr. McPherson, we would be pleased to have any statements you might want to give to the committee at this point. Then we will open it up to questions.

STATEMENT OF M. PETER McPHERSON, NOMINEE TO BE DEPUTY SECRETARY OF THE TREASURY

Mr. MCPHERSON. Mr. Chairman and Senators, it is good to be here this morning. I look forward to the possibility of serving as Deputy Secretary.

In my current position as A.I.D. Administrator, I have had really a very excellent experience in the ability to work, I believe, with Members of Congress; and that is critical in performing any senior executive function. I would certainly wish to do so in this position in the department. Thank you for allowing me to be here this morning.

The CHAIRMAN. Well, Mr. McPherson, that wasn't a very controversial statement you made. Let's see if we can't stir up a little interest.

Mr. MCPHERSON. Yes, sir.

The CHAIRMAN. I would like to ask you first if you have any particular philosophy about the tax system. How do you feel about the question of it being used just to raise income, to meet the expenditures of Government, or, contrary to that, it being used to achieve certain incentives or economic objectives for our country, be it savings or capital investment? Give me your ideological viewpoints in that regard.

Mr. MCPHERSON. I think the Tax Code, first and foremost, of course, is to raise revenue. That is the primary purpose, and it is important that it not become too complicated, too burdened; otherwise, voluntary compliance becomes more difficult to enforce. Voluntary compliance has been the key to our tax system over the years.

At the same time, it seems to me to be reasonable that the Tax Code and the Internal Revenue Service have other purposes as well. And I think that growth is so important to our society and

our capitalistic structure that we simply have got to have it. So, considering growth is a very important thing to do.

Accordingly, over the years, to use the Code in that fashion, I believe, is reasonable. As you know, in the 1986 Tax Reform Act, unquestionably because of the very difficult and important decisions that this committee made, we now have reduced rates. And I believe those reduced rates are in part to create the kind of growth and incentives that we need, and we need to try out that new structure to achieve those ends.

The CHAIRMAN. Let's look at the last tax bill. That was a monumental effort, one of the most major tax reforms in the modern history.

Some of the things will probably work fine, and others there may be questions about as we go along; but you can never anticipate fully how an economy is going to react to one of these things. Now, I understand that on Section 861, when you get into the question of the allocation of R&D and that part of it that goes to foreign operations, some kind of a compromise has been achieved between—or an agreement achieved—between industry and the Treasury in that regard.

That is fine. I am pleased to see it worked out, but I would like to know if there was loss of revenue in the process of that compromise.

The other question that comes up is a situation where Treasury has expressed misgivings about the application of the two percent floor on miscellaneous expenses to mutual funds. I would like something a little more explicit, if I can, on the question of what you would do to make up for the revenue that is lost in both instances?

Is Treasury going to make these kinds of accommodations and not be concerned about revenue neutrality?

Mr. MCPHERSON. The 861 foreign tax credit area is something I have done work on and am fairly familiar with, with its history. We think that what has been worked out is very reasonable and is important in terms of encouraging research and development. There are some revenue implications to it; over time, they could be fairly substantial.

We are aware of that, and it is something that we are anxious to talk to Congress about and some way find a solution to it.

As you are more intensely aware than I am, I suspect, Senator, virtually nothing that encourages these things—such as R&D or capital formation or whatever—is absolutely revenue neutral. As to the mutual funds provision, Senator, I have to admit that I am not aware of that provision. I would be happy to look into it.

I suspect, by the thrust of your question, it is not tax neutral either.

The CHAIRMAN. It certainly is not, and yet it is a legitimate concern; and I can understand the concern and the problems that would arise from an interpretation like that.

Mr. MCPHERSON. I think if things always had to be revenue neutral, then we would be hamstrung and could not show many problems. Unquestionably, we are going to have to get into some of the things that have a revenue impact.

The CHAIRMAN. Another problem you have is that the taxpayers are out there trying to understand what the regulations are going to be under this enormous tax bill. They certainly feel the necessity that those be expedited, and that we move along on them.

I would like to know what is being done in that regard, and what you know about it.

Mr. MCPHERSON. I have spent several minutes with the——

The CHAIRMAN. You anticipate that you yourself are going to be very much involved in the regulations?

Mr. MCPHERSON. I expect so. We will have to see how it actually evolves, but I will certainly be to some degree involved. I spent some time with the Commissioner of Internal Revenue on this question. I am aware that historically it has been difficult to get out some of these regulations, but it seems to me it is so critical to taxpayers.

I have talked to the Assistant Secretary for Tax Policy about it. I believe that more work can be done. They have done quite a lot, but more can be done. In fact I mentioned to Secretary Baker yesterday morning that it was an area of my interest, and I am sure I will be pursuing it.

They have issued press releases. They have issued some temporary regulations. They have focused on what they thought were the most widespread and critical areas; but it is a monumental job, and I can't believe that, if I get into it as Deputy Secretary, I can't have an impact, and I would fully intend to do so, Senator.

The CHAIRMAN. You know, up here we find often that one agency blames another, one division blames another, one bureau blames another. The rumor we are getting now is that you have got a real bottleneck in Treasury on these regulations, that they are not moving as fast as they should, and that decisions are not being made there as quickly as they should be.

And that is why I strongly urge you to get involved and be a part of that process and see if you can't break it loose and get it moving.

Mr. MCPHERSON. I promise to do so. There are 20-plus lawyers in the office of the Tax Legislative Counsel and there are another 50 in the Legislation and Regulations Division of the General Counsel's office in IRS. There is a TLC layer of review. I am not sure just what the answers are, but I have been managing a big Government agency now for six years; and I fully intend to get right into it and have an impact, as I say. And if there is something of special interest to you, I would be happy to report back to you in a timely manner and report on progress.

The CHAIRMAN. Mr. McPherson, let me get you to another area, and that is the question of trade. This committee has reported out a major trade bill that is going to the floor of the Senate. Treasury did not play a major role in that regard.

I would like to know your opinion if these trade barriers make a difference and if you think we ought to be doing something about them.

Mr. MCPHERSON. I think these trade barriers make a big difference. They are not the dominant difference in our trade deficit, by any sense, but they do make a difference. And I believe that we need to really work on these issues. We need national treatment for our businesses abroad. We need open markets. There is a whole

list of questions which should be addressed to Japan, but not exclusively to Japan; patent issues, a range of things.

And while USTR has taken the point position in the Executive Branch in dealing with this piece of trade legislation, clearly, Treasury is involved and we will continue to be involved, and I think that we must be involved.

The CHAIRMAN. Do you think we need a trade bill?

Mr. MCPHERSON. I think that a trade bill of the right balance could be very constructive. Obviously, we have a number of questions——

The CHAIRMAN. You are not going to get in trouble with that answer, I guess.

Mr. McPherson, what do you think the President's main objective ought to be at the Venice Summit?

Mr. MCPHERSON. In the economic area, Senator, I believe that we have got to enhance the coordination mechanism that has been evolving since the Plaza, through the Tokyo and the Louvre agreements. And I think we have got to make some further progress on stimulating the Germans' and Japanese economies.

The CHAIRMAN. How do you do that?

Mr. MCPHERSON. It is my belief, Senator, that the trade deficit is going to decrease. There is no way it can be sustained. I can talk, if you want, about what I believe has happened to it, and I believe there have been some changes; but there is no way it can be sustained, and that means really it is not just us that the Germans and the Japanese need to help; it is their own economies. They have got to get ready for a drop in exports. We are already seeing that.

So, we need to say—to the Germans and the Japanese—you have got to do this, in your own interest. The question is not whether it will happen, but the question is how much of an impact will it have upon their own economies. It could have a very dramatic, very negative upon their economies to the detriment of the world.

The CHAIRMAN. What is the alternative? For us to continue to have an enormous deficit? Doesn't that affect the fate of this country? And doesn't that in turn play off on the world?

Mr. MCPHERSON. I think that the trade deficit is beginning to turn, Senator.

The CHAIRMAN. As I look at it, it looks like it was $166 billion last year. If we annualize what has happened thus far this year, it looks like $160 billion. That is not much of a change.

Mr. MCPHERSON. Let me look at it in a little different way if I can. Last month the trade figures showed a 20 percent increase in exports over the January/February average. The March figure was 20 percent higher in exports.

The CHAIRMAN. And then we had an increase in imports?

Mr. MCPHERSON. Yes, but in fact, in volume terms, our imports are going down. The value of our imports is flat.

The CHAIRMAN. I understand that the securities markets don't look at volumes, they look at dollars.

Mr. MCPHERSON. I think they need to look more carefully in all candor, Senator, because there is no question our exports are going up. And exports mean jobs.

I think this J curve is taking a while to work, but in fact, we had such an overvalued currency that it is not surprising that it takes a while to work.

The CHAIRMAN. I have been arguing that point for a long time, and Treasury strongly opposed my arguments until Secretary Baker came along and changed that point of view. And I am delighted to see it.

But do you think currency changes—rate changes—will be enough to take care of the problem?

Mr. MCPHERSON. I believe that other things need to occur, like these further adjustments in the Japanese and German economies. And I believe that the kinds of discussions we are having, opening up these countries' borders further to our own trade, and further work on debt—all these things are part of it.

But I would return to my basic point, I guess, Senator. I believe that the trade deficit is going to go lower and that the Japanese and the Germans and the rest of the world have to get ready for that development and I believe the United States does, too. It is important that the trade bill—if that bill passes—be a bill which doesn't cause these countries to react against us at a time when, in fact, we need to and will be in a position, I think, to export.

The CHAIRMAN. Mr. McPherson, I think it is changing, too, and I sure hope so. I think it has topped. The problem is how long it is going to take to get us back into some reasonable balance where we can be in a position to start cutting down on that debt to creditors abroad. The exchange rates by themselves are going to be a big help, but they will not be enough. It is a many-faceted problem, and the trade bill will be one of those things that will help. I have taken quite enough of your time with my other colleagues waiting here to question you.

Let me state that the sequence of arrival is Packwood, Daschle, Rockefeller, Wallop, and Chafee. Senator Packwood?

Senator PACKWOOD. Mr. McPherson, let me pose a hypothetical. Assume long-term debt ceiling legislation passes in mid-summer. To it is attached a sequester over, but not the automatic Gramm-Rudman-Hollings sequester order process. Instead, assume it is more like the one that house Mojority Leader Tom Foley is talking about—a Constitutional provision, apparently, that would allow the President to sequester or not to sequester, at his choice. The process doesn't occur automatically, as under Gramm-Rudman-Rollings.

If he does sign a sequester order, it provides a 50/50 cut in defense spending and domestic spending. If he doesn't sign the sequester order, there is an increase in the deficit of whatever those sequestored amounts would otherwise be. So, let's assume we were $20 billion short of what I think will be new Gramm-Rudman-Hollings totals.

We are $20 billion short, and it is September, and The President either has to sign the sequester order, cutting $10 billion in defense spending from a level he believes is unacceptably low already and $10 billion from social programs or not sign the sequester order and have $20 billion added to the deficit. Or he could accept a $20 billion tax increase and fund the defense budget at a level that is reasonably acceptable to him and the social programs.

What would be your advice?

Mr. MCPHERSON. I think, as you understand, I would be hesitant today to give any definitive view on what I would recommend under circumstances that are some time off.

I would say this: It seems to me that when listing all the problems Senator Bentsen and I were discussing a moment ago, I probably should have brought up a couple different times the deficit because it is important. It is certainly a key to so very much, or an important part of so very much.

The deficit has been going down in percent of GNP terms. I think in 1983 it was 6.3 percent of the GNP; in 1986, it was 5.6 percent. And this year a $175 to $180 billion deficit will be about four percent.

Senator CHAFEE. About how much?

Mr. MCPHERSON. About four percent. Yes, sir. The trend is right, but we have got to sustain trend. And just how we get there is almost a central topic of discussion in this town, as we all know.

It seems to me that it is certainly reasonable when the Congress and the President agreed the other day that there would be, I think to quote the words "meaningful discussions" the President said that he would wish to enter into with Democrats and Republicans on the Hill concerning budget process reform. And I believe that is our first step, that we need to focus on that. The "Gramm-Rudman fix" I think was the term that was suggested that we would like to discuss, that that is the focus now.

And I hope, as I know you do—the many times that you have personally spoken about this—that we can get at this deficit.

Senator PACKWOOD. Let me interrupt. I want to know what your personal judgment is, not what the President may decide. Under the original Gramm-Rudman-Hollings law, a sequester order is mandatory; you have no choice.

Under the Foley proposal, as I understand what he is talking about, it is discretionary; you can sign the sequester order or not sign it. In your judgment which would be better: Signing the sequester order, and getting a defense budget less than you wanted and a social spending budget less than the Congress wanted but which reduces the deficit, or not signing the sequester order and having the deficit higher? Forget for the moment any taxes.

Mr. MCPHERSON. We have supported the Gramm-Rudman provisions, and the Gramm-Rudman provisions included a sequester.

Senator PACKWOOD. A mandatory sequester.

Mr. MCPHERSON. A mandatory sequestor. And it seems to me that, if we ultimately get down to that kind of issue without a tax increase—and that certainly is the Administration's position, that they don't want a tax increase—hat the budget is of enormous importance.

Senator PACKWOOD. And you would recommend signing the sequester order?

Mr. MCPHERSON. Well, for me to——

Senator PACKWOOD. I mean, that is your gut feeling? You would rather get the deficit down?

Mr. MCPHERSON. We have got to get the deficit down.

Senator PACKWOOD. All right. Second question.

Mr. MCPHERSON. I have got to caveat all this because I have to look at all this.

Senator PACKWOOD. You don't have to look at these carefully. These are philosophical answers. Sometimes, I would rather have your gut feelings than your intellectual knowledge. It is now September; you have got the Foley sequestor. You can either choose to sequester or not sequester.

Mr. MCPHERSON. Let me say one other thing, Senator, that we believe that the principal position right now in the Administration is that we want to engage with Congress in meaningful discussions on budget process reform, and that encompasses a lot of things.

Senator PACKWOOD. Yes, it does, but I want to come back to my question before my time expires. I was at a White House meeting the other day, and this argument was going around about meaningful budget negotiations and some kind of an enforceable budget procedure. I finally asked Howard Baker what he meant. What they mean is some kind of an agreement between Congress and the President that is enforceable. That isn't an enforceable budget process; that is an enforceable agreement, and I am not sure how you would get that.

I want to return to my hypothetical about it being the 1st of September again. Assume you are in meaningful negotiations with the Congress, not on budget process, but on a budget.

If you had to have taxes—the President's budget proposal already has got some taxes—would you please list for me, as best you can, the least worst taxes in order of increasing pain.

Mr. MCPHERSON. Oh, Senator, I don't think I will do that. I think that Senator Bentsen, in his gentle good way, asked me that question the other day. I just think that the position we have to take is that taxes are a burden on growth, that in fact Congress made a deal with the American people and the Executive Branch——

Senator PACKWOOD. Are they a different burden if they are proposed by Congress as opposed to proposed by the President?

Mr. MCPHERSON. I think taxes are a burden no matter who proposes them.

Senator PACKWOOD. No matter who proposes them? All right. Thank you.

Mr. MCPHERSON. Thank you, Senator.

The CHAIRMAN. I couldn't get him to answer it either. [Laughter.]

Senator Daschle?

Senator DASCHLE. Thank you, Mr. Chairman. I am fascinated by your ability to delicately dance around a lot of these questions, perhaps for understandable reasons. I would like to follow up on Senator Packwood's excellent questions in regard to revenue because we are faced with that prospect. Perhaps at one of the very next meetings we are going to be addressing reconciliation, and we may need to raise $18 or perhaps $25 billion in revenue.

As a direct follow-up to a question Senator Packwood just asked with regard to a burden on society, which in your view is worse: a deficit or the prospect of raising revenue?

Mr. MCPHERSON. I believe it is important—and I don't mean to dance—but I believe it is important to note that in fact the deficit has been going down in percentage terms.

Senator DASCHLE. No, that is not my question. Which is worse?

Mr. MCPHERSON. I know. And I think we need to keep up this effort of reducing the deficit. Now, I believe that we really should not be raising taxes.

Senator DASCHLE. Are you saying by that, then, that taxes are worse than the deficit?

Mr. MCPHERSON. I think that it is not——

Senator DASCHLE. Just yes or no. I mean, this is a simple question.

Mr. MCPHERSON. I really don't believe that, as I walk into this job, I should pick the worst of two very bad evils.

Senator DASCHLE. We are not asking for any specifics here. Just as Senator Packwood was saying, we want to know your gut feeling about it.

Mr. MCPHERSON. I believe that the deficit can be cut by cutting outlays, and that is the avenue to be pursued instead of choosing one of these two.

Senator DASCHLE. Let me just ask this as a follow-up then. Obviously, you oppose the revenue recommendations and budget proposals made by the Administration?

Mr. MCPHERSON. Those relatively modest revenue enhancements——

Senator DASCHLE. $26 billion?

Mr. MCPHERSON. No, no. There is $6 billion or so there, and the rest of those are, in fact, primarily sales of assets.

Senator DASCHLE. That isn't revenue?

Mr. MCPHERSON. It seems to me that we have to get through a rough period here and that the sale of those assets is a wise step.

Senator DASCHLE. I don't think anyone is sneezing at it, but that gets to the whole question about where does one go to raise revenues. There is no question that this Administration shares the view with the Congress that, in order to even come close to Gramm-Rudman this year—and I think it is generally recognized we fall far short—some $20 billion short—that we have the difficult prospect, whether we like it or not, of raising revenues.

You haven't been able to answer my question of which is worse. Facing that prospect of falling far short of Gramm-Rudman, we are coming to the conclusion that we are going to try to get closer, even if it means raising revenue.

Now, we are down to raising revenue, and I think what you are saying is that you will raise revenue; and, given the prospect of raising taxes or doing something else, you will do something else. Now, I want to touch on what it means to do something else. You are talking about raising revenue and the sale of assets. Does it concern you that the sale of assets is a one-time revenue gain?

Mr. MCPHERSON. It does not concern me because I believe that we are in the process—we could be if we hold tight to that—over the next few years of solving our trade deficit and our budgetary deficit set of problems.

Senator DASCHLE. That is such a Pollyannish response. Do you think that raising revenue by a sale of assets ought to be a practice that this country utilizes on a routine basis?

Mr. MCPHERSON. Yes, I think that some assets should be routinely sold. For example, I believe that when we extend credit, that it

is not unreasonable to sell them—to privatize certain aspects of our program.

And I also believe basically, Senator, that if a Deputy Secretary hopeful-to-be——

Senator DASCHLE. Let me just ask you one other question before my time runs out. If that is the case, how do you rationalize the fact that, while it is a short-term revenue gain, it is a long-term revenue loss? How is that budgetarily sound?

Mr. MCPHERSON. I don't necessarily accept your premise, Senator.

Senator DASCHLE. You don't?

Mr. MCPHERSON. I think that if we begin to sell assets——

Senator DASCHLE. It is not my premise, by the way. It is a CBO premise, and I am sure an OMB premise, as well.

Mr. MCPHERSON. You get a long-term loss in that you don't hold the paper and accumulate interest, but some of the assets, over time, we ought to be able to establish a system where we sell assets at their current value. A sale of assets may, in fact, put more discipline into our whole guaranty of loan system.

And I would say one other thing, too, Senator. I would argue that if I were to sit here as a candidate for Deputy Secretary and were to tell this committee today that I think that revenues are an option—or that taxes are an option—which I don't think should be the option—but if I were to imply that or say that, it seems to me it would further weaken the fiscal discipline that Congress and the Administration need to have.

Senator DASCHLE. My time is up, but I have to tell you that that is what concerns me. I really don't think you are being totally candid with us because I can't imagine, if you have come to the conclusion that revenue has to be the way in which we reduce part of the deficit, that you will do that through a process that has a budgetary cost that is far greater in the long term.

The CHAIRMAN. Mr. McPherson, I understand you are trying to get through a confirmation process here, but I would urge you to be more forthright. When we ask you for some gut feeling or some philosophical feeling, we are not asking what the Administration's position is or what your position will have to be, if and when you are confirmed.

We are trying to understand you; and when you get into one of these tax mark-ups, you are not going to be able to walk around these questions like that. You are going to have to take a stand and tell us where you are.

Senator Bradley wanted very much to be here. He had some questions he wanted to ask you, but he has to attend a funeral and can't be here; but I have a list of questions which I will present to you, and I want you to answer them for the record.

Mr. MCPHERSON. I look forward to it.

[The prepared questions from Senator Bradley and Mr. McPherson's answers follow:]

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

THE ADMINISTRATOR

May 26, 1987

Dear Senator Bradley:

Enclosed are my answers to questions delivered to me by Chairman Bentsen in connection with my confirmation hearing. I am also having these delivered to committee staff today for the record.

I hope to work with you on these and other matters in the future.

Sincerely,

M. Peter McPherson

Enclosures: a/s

Senator William Bradley
United States Senate
Washington, DC 20510

Hearing on the nomination of Mr McPherson to be
Deputy Secretary of the Treasury
Questions for the record
Senator Bill Bradley
Wednesday, May 20, 1987

What should the U.S. do to encourage G-5 cooperation at a time when poor policy coordination could bring on recession? Specifically, what should the U.S. do if it succeeds in making significant budget deficit cuts but Germany and Japan do not respond with measures to expand domestic demand such as tax cuts, more public investment, and measures facilitating private internal investment and consumer credit?

How important is U.S. budget deficit reduction? Is it more important than maintaining taxes at current levels or maintaining present levels of defense build-up? How much budget deficit reduction through further cuts in domestic discretionary spending is feasible and desirable?

Some say investment tax breaks in the 1981 tax bill sucked into the U.S. much of the foreign capital that raised the dollar to trade-battering highs in 1985, as well as raising the budget deficit and distorting capital allocation. Should the U.S. reinstate investment tax breaks given the implications for the budget, trade, and economic efficiency?

In what specific growth-oriented developing country reforms has the Baker Plan resulted? Has voluntary bank lending met the expectations of the Baker Plan? What are the financial needs of Latin America over the next five years? Where will the financing come from? Can we continue to rely solely on bank lending given the erosion of bank loan syndicates? Can we honestly expect more equity investment in the area given current levels of Latin indebtedness?

What steps should the U.S. take to prepare for the likelihood of more Latin American payment moratoria if conditions that have enabled Latin countries to stay current on their debt worsen? Specifically, what steps should the U.S. take regarding U.S. bank exposure if the trade deficit with Latin America disappears, interest rates rise, or industrial country growth stays below 2% per year?

How does your experience with the Peace Corps and with the Agency for International Development equip you to manage U.S. economic policy toward the developing world?

Question:

What should the U.S. do to encourage G-5 cooperation at a time when poor policy coordination could bring on recession? Specifically, what should the U.S. do if it succeeds in making significant budget deficit cuts but Germany and Japan do not respond with measures to expand domestic demand such as tax cuts, more public investment, and measures facilitating private internal investment and consumer credit?

Answer:

Let me begin by saying that I agree with the implication of your question that enhanced international economic policy coordination is important if we are to avoid the adverse repercussions of international imbalances.

An important step in achieving full cooperation is for the U.S. to carry out its end of the bargin. In particular, we must further reduce our budget deficit and enact only a sound trade bill. Now that exchange rates better reflect underlying economic fundamentals -- and our exports are about ready to make big gains -- the U.S. must be very careful about the trade legislation which it enacts. The growth and stability of the U.S. economy is a central cornerstone of the world economy as the U.S. reduces its twin deficits.

I believe that Japan and Germany will fulfill the commitments reached at the Louvre and Washington meetings to improve growth and reduce trade imbalances.

Japan has recently completed action on its regular budget and is expected to introduce shortly a supplemental budget of at least five trillion yen to stimulate domestic demand. We will continue to talk to the Japanese about exactly how this is structured and the timing of it.

Germany has already announced actions to meet its commitments to increase the size of tax cuts scheduled in 1988 and agreed at the recent OECD meeting to undertake adjustments to its economic policies in the event that growth falters. Unquestionably this situation continues to merit very close tracking and further discussions with the Germans.

It is important that we not think of these commitments from Japan and from Germany as largely favors to us. They are very much in their own interests. Our trade deficit is politically and economically unsustainable. Our trade balance, as measured in volume terms, is already improving. And, U.S. exports are

increasing in dollar terms. Japan and Germany are starting to feel the impact of lower exports and growth problems that are in part related.

As the trade adjustment progresses, Japan and Germany must take steps to reorder their domestic economies.

I think it is in our interest to encourage them, press them, but also support them. Major structural adjustments in export-oriented economies take time. None of us gain if the surplus nations slip into recession (nor do LDC debtors). We also need to ensure that other nations (e.g., the NICs) do not slip into the niche vacated by Japan.

In short, I think there is growing pressure on the surplus nations, which in time will become enormous, to re-orient their domestic economies. I believe that they will take the appropriate steps to do so, especially if we also make the right adjustments.

0706A

Question:

How does your experience with the Peace Corps and with the Agency for International Development equip you to manage the U.S. economic policy toward the developing countries?

Answer:

To live in a LDC is a tremendous advantage in understanding why things there work or do not work. There is no question that the Peace Corps, plus my work here at A.I.D., has given me a sensitivity to the political and social realities of the Third World. Because of that awareness, I devised the Executive Branch policy to use PL 480 programs where practical in connection with IMF adjustment programs. That effort is to target U.S. surplus food to populations badly hit by economic adjustments. I personally negotiated such programs in a number of countries including Bolivia, Guatemala, Jamaica, and others.

During my tenure as A.I.D. Administrator, I gained extensive knowledge about the economic problems in the Third World and the U.S. policy toward them. I helped make that policy during the last few years. Of special importance, under my direction, A.I.D. devised and implemented a strategy for promoting economic policy reform and market-oriented development in countries receiving U.S. assistance. I spent substantial time personally and dealt with many finance ministers and heads of states all over the world on these

issues. That approach has in fact made a major contribution, e.g., in large increases in food production in several African countries in 1986, large increases in non-traditional exports by Costa Rica and others. This effort is a major element of our international debt strategy and the U.S. policy toward multilateral banks.

I travelled extensively as A.I.D. Administrator throughout the Third World learning its problems and potential first hand.

At A.I.D. I had regular contact with the development banks and know them very well. At Treasury I would have a line role in connection with U.S. policy regarding these banks.

As A.I.D. Administrator, I also participated in the senior level interagency policy discussions on international economic issues. I am familiar with the process through which policy is formulated and I know well the people who make and implement those policies.

In sum, I believe I bring to this post a useful combination of experience with the policy development toward LDCs at the highest levels of the Administration, an appreciation for the important role and responsibility of the Congress, practical

knowledge on how policies do and don't work in both foreign capitals and the field, as well as an interest that has spanned two decades. I also recognize I have much yet to learn, but I am ready to focus on the pertinent questions.

0707A

Question:

Can we honestly expect more equity investment in the area given current levels of Latin indebtedness?

Answer:

I think so, and it is happening in some countries.

Equity investment, of course, relates higher returns and possibly more control with increased risk. From the beginning of the Program for Sustained Growth, the Administration recognized the important role of equity investment, but also realistically acknowledged that for some time the bulk of capital flows to the growing debtors would involve loans. The mixture will vary nation-by-nation and, indeed, even enterprise-by-enterprise within nations. The pace depends on factors such as the strength and sustainability of domestic economic reforms, local attitudes toward foreign ownership, the liquidity of equity markets, and the opportunties available in local industries.

Equity investment will take time, just as it took time to draw foreign equity capital, as opposed to debt capital, to the young U.S. economy. Its path will be marked by fits and starts. But I believe it is neither practical nor in our interest to forego the effort to encourage and nurture that

process. Our efforts must be carefully considered -- so we don't overwhelm the private nature of investment that is critical to long-term progress -- but they also must be persistent. So far, I think we are making headway.

Debtor countries are enacting domestic reforms, that should improve the potential for new equity investment. The reforms include liberalization of the investment climate, privatization, and efforts to develop domestic capital and securities markets in order to increase domestic savings. In addition, the recapitalization of both domestic industries and domestic banking systems has involved debt-equity conversions by residents and foreigners. This process should continue for some time as long as there are adequate supplies of good quality investments.

Countries with officially-supported swap programs in place have been able to attract additional foreign direct and portfolio investment as well as the return of flight capital. We are encouraged by the levels of swap activity in Chile and Mexico. Argentina, Bolivia, Costa Rica, Guatemala and Venezuela are considering similar programs. But in order for swap programs to be effective, restrictions must be kept to a minimum. A number of developing countries are issuing convertible bonds in the international capital markets and

through private placements. In addition, new mutual funds have recently been established to take advantage of foreign investor interest in emerging capital markets, including those in developing countries. This trend of substituting the issuance of marketable securities for bank borrowings is likely to continue worldwide. And I am encouraged that various financial firms have recognized the potential for these markets and are infusing them with a wealth of innovative approaches.

In addition, capital flight has slowed or reversed in many countries. -- a vital reward for improved domestic policies. For example, in 1986 Mexico had a net $1.5 billion return to the country. I believe a substantial portion of this money is in fact brought back in for investment purposes.

Last year the 15 debtor countries covered by the Baker Plan grew an average real rate of 3.5 percent. While we hope they will do even better, this growth is far more hopeful than their posture a few years ago; halted in their tracks or slipping back. It certainly is possible for rational investors to make long-term business commitments in some Latin American enterprises in these early stages. This is especially so if the economic policy decisions are sound and form the basis for future business earnings.

0708A

Question:

Some say investment tax breaks in the 1981 tax bill sucked into the U.S. much of the foreign capital that raised the dollar to trade-battering highs in 1985, as well as raising the budget deficit and distorting capital allocation. Should the U.S. reinstate investment tax breaks given the implications for the budget, trade, and economic efficiency?

Answer:

No, the Tax Reform Act should be given time to work. Changing the tax rules continually increases investor uncertainty and discourages long-term investment.

As the years go by, I think the work of you and your colleagues will even gain in respect. In a political system, characterized by incremental change, the Congress and the President succeeded in fashioning truly comprehensive reform.

At the heart of the 1986 Act was a simple but powerful notion: We can improve long-term economic performance by eliminating distortionary tax influences on private decisions. The lower tax rates on personal and corporate income, combined with base broadening , encourage better economic performancce by promoting more efficient use of our nation's productive resources.

It would be a mistake, in my view, to return immediately to the special interest battle to fiddle with (or even dissemble) the components of the 1986 Act. The Act should be allowed to take effect without reconsidering major issues, including investment incentives. I am sure that investment incentive ideas will be (and indeed should be) reviewed in the years ahead in light of the experience accumulated under the 1986 Act. But, for now we need to give that Act a chance to work.

0709A

Question:

In what specific growth-oriented developing country reforms has the Baker Plan resulted?

Answer:

Colombia clearly stands out as a country that has successfully adopted economic reform. Colombia has adopted significant trade, agricultural, and foreign exchange reforms, has followed sound fiscal and monetary policies, and has managed prudently last year's coffee windfall to finance rural investment and reduce foreign debt.

Financial markets have responded favorably, enabling Colombia to place successfully a $40 million bond issue in the Japanese market last year and to issue a $50 million floating rate Eurodollar note this year -- the first voluntary Euro-financing since 1982.

The Philippines is implementing comprehensive economic and financial reforms, including: the reduction of controls on imports, and the break-up of the coconut and sugar monopolies. I have been close to these efforts because we have used the U.S. foreign A.I.D. program to support reforms there.

In March, creditor banks rescheduled $13.2 billion of the Philippines' debt over 17 years. As part of the accord , the banks have the option of accepting a portion of interest payments in the form of notes, or Philippine Investment Notes (PINs), which are issued by the central bank of the Philippines. The notes are structured so that investors can exchange notes at the Philippine central bank for equity positions in the economy.

Argentina has enacted a number of policy changes under the Austral Plan, including: the reduction of the fiscal deficit from 12% of GDP in 1984 to less than 4% in 1986, tax reform to increase the tax base and improve tax enforcement, the removal of quantitative restrictions on trade, the lowering of tariffs and export taxes, and a new trade pact with Brazil and Uruguay. The government has made moves to privatize public sector enterprises, including the sale of oil exploration leases, the establishment of a new managing board for state enterprises led by private entrepreneurs, and discussions regarding the sale of some public sector railroad lines and domestic national airlines.

As a result of these policy changes, Argentina reached a debt accord with its major creditors, including the rescheduling of $30 billion of its external debt, $1.95 billion

in new loans, a program for debt/equity swaps, and a program whereby each creditor bank can convert up to $5 million of existing Argentine loans into longer-term instruments. The World Bank recently agreed to lend $500 million to Argentina to help the country finance a new trade policy that stresses growth based on exports. On May 19, the Government of Argentina also reached agreement in the Paris Club on the rescheduling of about $2 billion in outstanding debt to official bilateral creditors.

The Government of Chile has pursued a policy of increasing domestic savings and re-orienting the economy toward export-led growth. The economy improved substantially in 1986 -- real GDP grew by 5 percent and inflation was reduced from 31 percent in 1985 to 16 percent . Despite declining copper prices, export revenues were boosted by more than 6 percent.

Chile has made substantial progress in reducing its external debt service burden through debt-equity swaps, which exceeded $1 billion in 1986. Further, the country reached a retiming and repricing agreement with commercial banks.

There are certainly other examples as well. In my opinion, these reforms, as difficult as they may be to accomplish, are fundamental to long-term developments and growth. They help

generate internal capital, draw and return flight capital, attract foreign capital, and make it possible to improve the prosperity of the citizens. Growing debtor nations will, in turn, contribute to the economic well being of our interdependent world economy -- including that of the U.S. Furthermore, I think the prospect of economic hope can support the emerging democracies that are pressing ahead in many of these nations.

0710A

Senator Bradley

What are the financial needs of Latin America over the next five years? Where will the financing come from? Can we continue to rely solely on bank lending given the erosion of bank loan syndicates?

Answer:

Mr. McPherson:

Calculating the external financial needs of Latin America for the next five years is a complex process and is subject to considerable variations. An estimate depends on a number of factors, including: the debtor nations' effort to enhance domestic savings and investment; growth in both debtor and creditor nations; debtor access to markets and export earnings; the level of interest rates; and other non-debt creating flows, debt sales or debt conversions -- including foreign investment; the repatriation of flight capital; and debt/equity swaps.

As you know, the "Program for Sustained Growth" outlined by Secretary Baker in October 1985 projected a need for approximately $20 billion in net new commercial bank lending over a three year period. He also called for $9 billion in enhanced lending by the multilateral development banks (or $27 billion in total MDB lending) to supplement expected IMF and official creditor financing for the 1986-88 period. These numbers were based on global economic outlook projections at

that time and were targeted to achieve 5 percent growth within the major debtor nations by 1988. Changes in oil and other commodity prices, interest rate levels, and OECD growth prospects since that time have had varying effects on individual debtors' financing needs.

IMF projections of 2.5 to 2.8 percent growth in the industrial countries during 1987-88 (along with relatively stable interest rates) are consistent with a $6 billion improvement in Latin American current account balances during this period. Such an improvement (or slightly less if OECD growth is less) would reduce these nation's external financing needs by a similar amount.

Under the IMF's medium-term scenario of 3 percent average growth in real GNP in the industrial countries and almost 5 percent real GNP growth in the major developing countries during 1989-91, the export earnings of the major debtors should expand sufficiently to permit them to service their debt and pursue domestic growth-oriented policies with less reliance on external financing. Indeed, the IMF projects that in 1991 the ratio of debt to exports of goods and services for the Western Hemisphere debtors as a group will drop from last year's level by almost a quarter.

I think that the agreement to have "meaningful" negotiations between the President and Congress on the budget process is an important step. Some of the slippage and weaknesses of that process have contributed, I believe, to our inability to reduce the deficit more quickly.

0711A

Question:

How important is U.S. budget deficit reduction? Is it more important than maintaining taxes at current levels or maintaining present levels of defense build-up? How much budget deficit reduction through further cuts in domestic discretionary spending is feasible and desirable?

Answer:

The U.S. budget deficit is extremely important. We are consuming more than we should tax to pay for it. Moreover we are borrowing from abroad so that we will need a current account surplus in order to earn the money to pay back the borrowed money and interest. Whenever you talk about any serious economic question, e.g., trade deficit, monetary policy, coordination of international/macroeconomic policies -- you bump into the central fact of the huge budget deficit. There is no question that there has been some progress (the deficit was 6.3% of GNP in 1983, was 5.3% in 1986, and we forecast it will be 4% of GNP in 1987), but we must continue to reduce the deficit.

I don't think we should reduce the deficit by increasing taxes. The President proposed some user fees and adjustments in revenue programs, but to really increase taxes would be a breach of faith for those who gave up tax benefits under previous law and supported the Tax Reform Act of 1986.

Moreover, additional taxes could reduce growth and threaten a successful recovery well into the fifth year. Any suggestion that higher taxes are an option might contribute to further erosion of fiscal discipline.

The American people are not undertaxed. Tax projections suggest that taxes will encompass slightly over 19 percent of GNP in coming years -- nearly one percent of GNP above the levels from 1965 to 1979. Currently, outlays are well above their historical level of about 20 percent of GNP. A tax increase to close the gap will shift our nation to a new threshold after over two decades of basic continuity. A higher threshold of American taxation will weaken our private sector and lower incentives to entrepreneurs, and business workers. It would hardly be an encouraging step for a nation moving to maintain world economic preeminence in the next decade.

I think we can continue to reduce the growth of federal spending by cutting outlays on domestic programs. Defense expenditures have already been cut substantially and further reductions would be imprudent. As you know, the President proposed a substantial number of cuts in discretionary domestic spending and I support those efforts.

I do not expect the commercial banks to be the sole source of external financing for the debtor nations. The debt strategy envisioned that both the international financial institution and the commercial banks would increase lending to the major debtors. It is possible that innovative proposals involving surplus nations, such as those apparently being considered by Japan, could further enhance the contributions of the multilateral institutions. The debt strategy also emphasized the need to develop financial flows other than debt.

A large component of this financing is often available right at home if the debtors institute sound economic policies to reward saving and local investments. The return of flight capital can make an enormous difference for many of these economies. Note the $1.5 billion that returned to Mexico last year.

2416C

Question:

What steps should the U.S. take to prepare for the likelihood of more Latin American payment moratoria if conditions that have enabled Latin countries to stay current on their debt worsen. And specifically, what steps should the U.S. take regarding U.S. bank exposure if the trade deficit with Latin America disappears, interest rates, or industrial country growth stays below two percent a year?

Answer:

I know that this will be a set of issues that we will discuss in the future and I look forward to it. However, I believe that the widespread moratoria your question envisages are not likely. Indeed, I think that the Program for Sustained Growth has had an important impact in its relatively short life. This problem -- including both the structural impediments to growth and the large debt -- took some time to form. And, I don't think there is a quick answer. The debtor nations cannot withdraw from the international financial system without inflicting long-term damage on themselves. Nor should we think the U.S. would gain even if such a withdrawal could be effected with minimal harm to lenders. The future prosperity of the debtors is linked to the health and strength of the major market economies and steps they must take. We will no doubt need to work very hard on the problem and to adjust our approach some as we proceed, but that basic approach remains sound in my view.

As for steps to prepare for particularly adverse circumstances, I think it is useful to examine two different categories of actions: (1) avoidance; and (2) coping with widespread moratoria.

Avoidance steps include the continuing process of innovating ways to draw private capital to the debtors. For example, the "menu" approach encourages the formulation of a variety of investment methods so as to better draw and retain a wide range of investors.

Avoidance also involves pressing for full and effective development of the resources of the multilateral financial institutions to assist the debtors. Obviously, the multilateral involvement should encourage growth-oriented reforms and reasonable ongoing participation in the international lending process.

As a practical matter, avoidance also relies on the examples of nations that have stopped repaying their debts. Their plight is not a fortunate one, and the economic uncertainty created by debt moratoria soon impacts on a variety of lending (including short-term or export finance) and business activities.

The appropriate international economic climate is another element of avoidance.

Current projections of OECD economic growth in 1987-88 are down from 1986 levels, and we are, as you know, working on this issue. However, the substantial reduction in interest rates since 1984 has lowered developing countries debt service burdens. We therefore expect the debt situation to remain manageable in the next year.

While short-term dollar LIBOR interest rates have risen somewhat in the past few months, German, Japanese, and U.K. interest rates have declined. In general, the industrial nations recognize the importance of global economic growth, supportive interest rate levels, and access to open and growing export markets for the debtor nations. They are working on the cooperation to sustain and improve progress in all these areas.

I do not believe it likely that other Latin American countries will declare a moratorium on payment of debt such as Brazil has done. Argentina and Venezuela recently reached rescheduling agreements with commercial banks, Chile has negotiated a retiming and repricing agreement, and the Mexican

financing package has been completed. These and other new money packages should provide significant net commercial bank financing for the major debtor nations during 1987.

In the unlikely event more debtors turned to debt moratoria, I believe the U.S. banking system would be better prepared to cope than it was only a few years ago. As Comptroller of the Currency Robert Clarke testified recently, national banks have augmented their capital during the past five years -- partly because of the encouragement of the banking regulators.

Since 1980, the average primary capital ratio of national banks have increased from 9.2 to 9.8 percent. (The absolute level of primary capital at national banks has nearly doubled over this period, rising from $69.9 billion in 1980 to $124.6 billion in 1986.) The capital increases have been most notable of the largest banks. Comptroller Clarke stated that office's Multilateral Banking Department has judged nine of the ten largest national banks to have adequate capital. Capital at the 10th is considered marginal; its primary capital is within regulatory guidelines, but a relatively high proportion of that capital is in the form of loan loss reserves. Therefore, the OCC has asked this bank to raise equity.

I heartily endorse the vigilant examination and supervision of U.S. banks by the regulatory agencies. As you know, the International Lending and Supervision Act of 1983 mandates certain reserves under conditions that may be created by the hypothesis you pose. I would expect the banking regulators, acting on a case-by-case basis, would monitor and seek provisions of capital (whether reserves or equity) to help prepare for such eventualities.

Certainly Citicorp's recent decision to add $3 billion to its reserves is indicative of an increased capability of at least some of our major banks to approach the debt problem with greater flexibility. It may give Citibank and the debtor countries more options.

I should note, however, that I do not consider prudent behavior by our banks and their regulators to be a substitute for continuing to work on the program to achieve sustained growth in Latin America. The economic success of our hemisphere is too important an objective. And the success of democratic political regimes often associated with those growing economies is vital to us, too.

I might conclude by noting that the problem with Africa's debt, which is largely official debt to governments and international organizations, is somewhat separable from the debt issues of most of the Latin countries. We need to continue to work on the Africa debt problem, for example through liberalized terms for Paris Club restructuring. I understand this item may be one of those discussed at the Economic Summit in June.

2745D

Question:

Has voluntary bank lending met the expectations of the Baker Plan?

Answer:

As Secretary Baker has stated, Commercial bank lending to the major debtors last year was clearly disappointing. The new money package for Mexico was a considerable bright spot given its earthquake and dependence on oil for export revenues when the price of oil fell sharply, but that arrangement took a considerable amount of time and effort to complete.

The difficulties stem from a number of factors: numerous banks with small exposures which are reluctant to increase lending; difficulties in communication within the bank group; an inability of banks to concentrate on more than one major new money package at a time, and, of course, the difficult tasks of implementing believeable adjustment policies in the debtor nations.

Fortunately, the outlook has been improving. Progress has been made recently in completing a repricing and retiming agreement with Chile, rescheduling arrangements for Venezuela and the Philippines, and a new money and rescheduling agreement with Argentina. Other discussions are also well underway.

Together with the Mexican and Nigerian new money packages, these should provide substantial net new lending for the major debtors this year. But some underlying problems in organizing new lending packages remain. The major debtor nations need to be able to count on receiving timely disbursements of new loans essential to support well-conceived economic programs.

To help address these problems, Secretary Baker has called on the commercial banks to develop a menu of alternative new money options from which all banks with debt exposure can choose in providing continuing support for debtor reform. These efforts to provide a range of financing alternatives should help to keep the banks' doors open to international finance, which is vital for the continued implementation of the strengthened debtor strategy. The commercial banks have been receptive to this call for a "menu" approach, and are in the process of considering possible options.

2746D

The CHAIRMAN. Now, the next questioning sequence will be by Senator Rockefeller.

Senator ROCKEFELLER. Mr. McPherson, I agree with what the chairman has just said. I mean, this is the number two position in the Treasury that we are talking about. We are not asking for the Administration's position. We are trying to get a sense about you.

I value the fact that you have served the Government for a long time. You and I both have worked for the Peace Corps, and that is fine. This is a very important position, and I would like to hear the word "we" a little less and the word "I" a little more in some of the answers.

Let me ask you this. Other than reducing the budget deficit, what are about four or five things that you think we need to do in this country to make ourselves more competitive, as they say; and what are the budget implications of the answers that you might give us?

Mr. MCPHERSON. I believe that the competitiveness steps that we need to take are in many cases long-term steps. The basic education system in this country needs to be strengthened in many ways, I think.

Senator ROCKEFELLER. What do you mean by "a number of ways"?

Mr. MCPHERSON. It seems to me the scores—the SAT scores for high school students—or elementary testing, that the basic education system in this country isn't as strong as it should be, or it isn't as strong in this country as it is in some others; perhaps it isn't as strong here as it was a few years ago.

Senator ROCKEFELLER. Do you think that can all be done by non-budgetary measures?

Mr. MCPHERSON. I think that some budgetary expenditures are no doubt involved. I don't think it is enormous. I think a lot of it is just school boards around this country deciding they have to get higher scores; and some of that is beginning to occur. In the last couple of years, there has been a focus on education in this society. I noticed the other day there was a national system discussion about certification of teachers.

This is the kind of thing I mean; it wasn't a Federal Government activity, that was the profession itself. Some of this has budgetary impact, but a lot of it—and I would suggest the majority of it—is not Federal Government activity—some, but not the majority.

I think that the whole area of science and technology is very important. At AID, I put a very strong emphasis upon R&D. We did some very interesting things like developing a malaria vaccine that is now being field tested. That was for LDC purposes, but it is important to have a R&D focus in our society. Universities and the private sector working together to achieve things has begun to happen, but it needs to happen more; and there is at least some budgetary impact upon that. You Senators are aware of what the President has been talking about, but there is a whole other range of things here.

I believe that the whole issue of where we go with GATT is pretty key, and there are some macro issues here as well. There is a sense of labor and management working together to solve some problems.

A sense in this society, and I heard you give a speech to this effect—you remember, at the Peace Corps anniversary--where you argued that we, as a society, had to come to grips with the fact that we are not as competitive as we perhaps once were and certainly need to be. And it is everybody from the President on down to the schools and companies and workers and unions deciding they are going to do something about it.

Senator ROCKEFELLER. You mentioned that we ought to have a trade bill that has the right kind of balance. You look at Japan and their unwillingness really to open up their markets to us. When they finally do open up their markets to some degree, it is only after they have protected those markets for a number of years. Those industries underwent a weeding out so only the best survived and developed adequate productivity and capacity. Do you think that the trade bill that we have passed in the Senate will cause the Japanese to open up their markets? Do you think that bill has the right kind of balance to do that?

Mr. MCPHERSON. I would like not to hold myself out as a trade expert on the Senate bill versus the trade bill of the House. I think that generally what we need to look for is substantial discretion between the Executive Branch and the USTR and the President, as opposed to mandatory retaliation. I realize that there are major differences between these bills.

I think that we have done a good deal in the last year—in the last couple of years—in the use of 301, for example, with Executive Branch initiation and six 201 cases that were looked at and ostensibly four which we in fact pursued.

I think that we are making some progress here. Obviously, Congress is expressing broad interest in this topic. There is no final judgment made here as to what will happen to a particular trade bill, but I would be a little uneasy about it. And I think that everyone feels that when the House and Senate sit down and work this out and talk to the Executive Branch further about it that some further steps will be taken.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Wallop?

Senator WALLOP. Thank you, Mr. Chairman. Mr. McPherson, you cited your tenure at AID. I guess one had better use that abbreviation rather specifically nowadays, AID. [Laughter.]

During your tenure as Administrator of AID, did most of the policies reflect your basic philosophy?

Mr. MCPHERSON. Largely yes, sir. I was certainly there long enough to do it.

Senator WALLOP. Then, perhaps we can find out something about your view on taxes. As a part of an Administration that gave tax cuts a high priority, why was it that AID pushed AID recipients to increase their taxes and screw down their economies?

Mr. MCPHERSON. There were very few circumstances where we ever argued for tax increases, but we did often argue that revenues or fees should be increased in countries like El Salvador and Costa Rica and other places in connection with services provided by the government. For example, Costa Rica was charging much less than the actual cost of electricity and water to the people who received

those services, and we said you should get back at least what it cost.

In fact, I made a big distinction between income taxes versus retrieving money or fees for services rendered.

Senator WALLOP. Then, let me ask it from another perspective. Less than five percent of AID funds went to the private sector. Why would AID place so little emphasis on that?

Mr. MCPHERSON. Senator, with all due respect, I don't agree with the basis for that figure because, while about five percent went directly, the private sector role was much greater.

Senator WALLOP. What you are saying then——

Mr. MCPHERSON. About 4.4 percent went directly to private enterprises, seven or eight percent went to private voluntary organizations in non-Government projects, with about 48% of AID's assistance expended in ways that benefit the private sector. In our ESF program, for example, this year we are providing substantial money to various countries through private banks.

Now, I think it depends upon definition. We have a very private sector oriented program at AID.

Senator WALLOP. Less than one percent of the expenditures in Grenada went to private enterprise, and it would seem that AID was essentially supporting socialism in a nation that we just rescued from Marxism.

Mr. MCPHERSON. We built roads. We built an electrical power system, or spent money for it. We worked hard in Grenada to get high tax rates cut in connection with providing our money. Taxes were substantially higher and graduated; we worked hard to reduce them there. These things were very important for the private sector, more important than most direct assistance to it.

Incidentally, I think we were an important part of getting Jamaica to reduce their high graduated income tax rate structure. I would argue essentially, Senator, that the reduction of Government's role in GNP, that making market forces more important—that those two factors were prominent throughout what we did at AID.

For example, in Africa, all over the continent when I arrived in 1981, governments were holding down prices to farmers for their products. We argued again and again—in fact we conditioned our money on their allowing the farmers to receive more, and the benefits were evident all over the continent. Many countries are raising their prices, and farmers are producing. It was that market orientation that I pursued.

Senator WALLOP. As a part of approaching the concept of a trade deficit, it seems inconceivable to me yet that this Congress can imagine a trade deficit reducing with one or another country, but not overall, so long as that Third World debt hangs so heavily on their ability to repay.

And when they must, of necessary, to service us and squeeze down their economy so that everything goes to export and no growth programs are contained inherently within it, how can they run a trade neutrality with the United States and ever be expected to satisfy their debts?

Mr. MCPHERSON. To begin with, what we need is more Third World exports to Japan and Europe. We cannot continue to be the

recipient of the solid majority of Third World manufactured exports.

Senator WALLOP. Would it be your position that we can, somehow or another, orchestrate that and manipulate that to our own advantage, absent any market forces that may exist?

Mr. MCPHERSON. If I understand your question, what we need to be working on is having Japan open its markets, not just to us but to the world—if that answers your question.

Senator WALLOP. That is true, but if we expect Japan to engage in large support of Third World economies and development over there, you can well believe that one of the things they will be doing is carving out the corners of those markets for Japan, not for the U.S.

The CHAIRMAN. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman. First, Mr. McPherson, I would like to pay tribute to you for your long Government service. You have truly devoted a good portion of your life to the Government, and I think all of us should be grateful for that. You have been a good citizen; and I, for one, want to express my appreciation for that.

Second, I would like to ask you: Do you see the trade deficit as involving far more than the need for a good trade bill?

Mr. MCPHERSON. Oh, yes, I think that is clear.

Senator CHAFEE. Well, I don't think that is so clear in the Congress. I think there seems to be an attitude in the Congress that if we get a good trade bill and show those Japanese who is boss, things are going to straighten out.

How much would you say of the trade deficit of $170 billion is due to lack of proper access to our products?

Mr. MCPHERSON. There has been a figure kicked around of $6 or $7 billion. I am not sure that it is that low, but——

Senator CHAFEE. Well, it has squeaked its way up to $20 billion.

Mr. MCPHERSON. Yes. That is what I have heard, but let's say it is higher. Let's say it is two, three, or four times that.

Senator CHAFEE. Let's say it is $30; that leaves $140 to go, doesn't it?

Mr. MCPHERSON. Precisely.

Senator CHAFEE. Are you going to be a strong voice on other things, on our achieving competitiveness in other areas?

Mr. MCPHERSON. I think that is critical. I believe my comments a few minutes ago indicate my belief that we need to do other things, to worry about the superconductor for example.

Senator CHAFEE. Are you willing to propose rather radical approaches? Let's take the superconductor. Why shouldn't we recognize this as a very, very specialized area and maybe change for that product, if you would, our antitrust laws? How does that strike you?

Mr. MCPHERSON. That is very interesting. The antitrust laws which have restricted combinations of entities for production and sales to our detriment have been problems.

Senator CHAFEE. Are you going to speak out on that?

Mr. MCPHERSON. The antitrust is an area I have been interested in, and I am sure I will get more deeply into that problem. I have done some work on competitiveness.

Senator CHAFEE. Are you going to speak out that competitiveness, as defined in the antitrust laws, recognizes only national competitiveness and doesn't recognize international competitiveness?

Mr. MCPHERSON. Yes, Senator. I believe that is right.

Senator CHAFEE. Now, we have had testimony before this committee from people we respect that, in the order of priority of the most important items dealing with the trade deficit, one through ten, it would be the Federal budget deficit; and you yourself have testified to that. Are you going to be a voice that would speak up in the councils of the Government and say to the President or to your superior, the Secretary: We ought to have a summit between the President and the leadership of Congress to arrive at some conclusion that might well involve cuts in defense, cuts in domestic spending, and an increase in taxes?

Mr. MCPHERSON. I seem to get in trouble in this area this morning, Senator.

Senator CHAFEE. That is all right—get yourself out of trouble. [Laughter.]

Mr. MCPHERSON. I really believe——

Senator CHAFEE. I mean, you yourself have said that the deficit is the most important.

Mr. MCPHERSON. I did.

Senator CHAFEE. Now, to run around and talk about cutting school lunch programs and cutting school and college tuition and grants, you must recognize that that is not going to fly.

The President's budget was defeated in both Houses of this Congress. I think out of 535 votes, it had something like, I would suppose, less than 20. So, where are we now—in 30 seconds?

Mr. MCPHERSON. The President has agreed to look at the budget process with Congress, and I think that is an important step.

Senator CHAFEE. But, Mr. McPherson, we keep hearing that. Now, do you really believe that the line item veto or the Balanced Budget Amendment or budget process reform is truly going to do anything about stepping up to the mark and reducing the deficit?

Mr. MCPHERSON. I think that they can play a role, Senator. Essentially, we need to be sure that—as Senator Packwood quoted White House sources just a few minutes ago—we need to be sure that we have a process that whatever we agree to, in fact, will function. I think the process is an important thing to do at this time, and I know that it is the feeling of some here that I am not being forthright; but I honestly believe, if I were to come in here this morning and say, frankly, if we can't solve the problem of the deficit by these other ways, then I am for increased taxes, I believe, one, that we should not do that and, two, I think if I were to say that, I would be undercutting the discipline——

The CHAIRMAN. That is exactly right; I understand. Thank you very much. [Laughter.]

Senator Moynihan?

Senator MOYNIHAN. Mr. McPherson, we have visited, and I welcome you on this occasion; and I know that anybody who has been through the AID Program in this decade is going to have no difficulty with this committee. I would echo Senator Chafee's remarks about your Government service; and I would note that Mr. McPherson is one member of the now-growing and distinguished

group of public officials who joined the Peace Corps as their first overseas experience.

And it was always thought in the early days—it was 1964 I think when you went in—that Government service would follow that involvement. Where did you go in the Peace Corps, if I might ask?

Mr. MCPHERSON. I was in Peru.

Senator MOYNIHAN. In Peru? Yes. And you grew up, one might say, to be head of the AID Program; and I dare to think that you are the first director of AID who has been appointed to a high subcabinet position. It is not a normal experience for directors of the AID Program, and I congratulate you for that.

Mr. MCPHERSON. Thank you.

Senator MOYNIHAN. Could I ask about a matter that is on our front pages this morning? The decision of the CitiCorp to write off a portion of its sovereign debt overseas—some $3 billion—and as a result to incur a net $2.5 billion loss for this quarter; could you give us your thoughts on how you respond to that as a soon-to-be Treasury official? It is obvious that the bank was in a position to do this; it had the money and other profit-producing activities domestically, and I guess the bank has had a policy of increasing reserves over recent years, sort of ahead of some other banks in that regard.

It has obviously been able to find in its own cash drawers the money to do this. Could you give us some thoughts on this? Would you think, as obviously I do, that this was a prudent and sensible demonstration, that the system is quite viable as it is; and negotiations should continue, and the Baker Plan should be pursued?

Mr. MCPHERSON. Yes, Senator. I view this as a positive development. I think it shows a strong bank.

Senator MOYNIHAN. A strong bank?

Mr. MCPHERSON. Yes. I think it was, in fact, a decision apparently by the bank itself. There were indications yesterday that the regulators don't see this as something that all the other banks must do.

Senator MOYNIHAN. If I could just interrupt, I think Citicorp Chairman John S. Reid, in a statement he issued, has indicated he sees no need for others to follow this pattern. They don't have the extent of overseas commitment that Citicorp does nor overseas operations.

Mr. MCPHERSON. That is correct.

Senator MOYNIHAN. That is correct?

Mr. MCPHERSON. The regulators are together essentially saying that they will continue to look at the overall capital position of the banks—the other banks—which they have been doing. I would like to suggest that this move on the part of Citibank should allow them somewhat more flexibility—at least they suggest that, and it appears that way to us—in responding to various initiatives of the LDCs, things like debt equity swaps, other structural changes, and so forth.

I mean, there is going to be a lot of discussion about this in the next few days. I am sure there is not a money center bank in this country that didn't think about this long and hard last night; but in general, it seems to us to be a positive development.

Senator MOYNIHAN. It seems to you to be a positive development?

Mr. MCPHERSON. Yes, sir.

Senator MOYNIHAN. And you think it is consistent with the Baker Plan?

Mr. MCPHERSON. I do, indeed.

Senator MOYNIHAN. You do, indeed, think it is consistent with the Baker Plan?

Mr. MCPHERSON. I think that because, among other things. CitiBank has indicated that they intend to continue to play an important role in these Third World debt issues and continue to provide resources.

Senator MOYNIHAN. CitiBank is not withdrawing from the international scene by any means. They said that this is going to put them in a position that no one can question the stability of the bank—no one ever has—but right now, it is sort of a preempting measure so no one ever will. Wouldn't you put it that way?

Mr. MCPHERSON. Yes, I think that is fine.

Senator MOYNIHAN. I am glad to hear that. You have answered all my questions, and I didn't even ask you about taxes. Mr. Chairman, I think that is a point I would like to repeat. Mr. McPherson comes from a line of former Peace Corps volunteers who have indeed fulfilled the expectation to return to Government service; and not everybody can handle the foreign aid program in this Government and be asked to continue in an even higher post. It speaks to your personal qualities.

The CHAIRMAN. Thank you, Senator Moynihan. There will be other questions for you—written questions—that we will ask answers for. And in line with what Senator Moynihan was saying, I am delighted to see the move by the CitiBank. It is very much needed. I am one who thought that we could not, by legislation, mandate these kinds of reserve requirements because of variance amongst individual institutions; but I thought frankly that it was overdue, That it should have done and that is was a positive stop and the prudent thing to do. I think that, in spite of comments about other banks, other banks will have to do it, too. It will vary somewhat by their own particular conditions and their own portfolios.

The German bankers have been leaders in taking this kind of a prudent course of action; and I am glad to see CitiBank make the move that they have. That is the way it should be done, rather than by Congress passing a piece of legislation that would have forced that.

I don't know whether or not the Federal Reserve was a part of that decision, but frankly, I hope they were. That is a part of their responsibility.

The CHAIRMAN. Now, Senator Packwood, do you have any further comments?

Senator PACKWOOD. A couple more. Do I understand your theory that part of the trade deficit—or a significant part of it—is caused by the immense national budget deficit?

Mr. MCPHERSON. There is a lot of dispute about that as to the connection, but it is clear that a very substantial amount of re-

sources have gone in the field of notes and bonds. So, it seems to me that there is a connection. Exactly where and how much and so forth, I hear different theories as I prepare for this job; but I go back to the idea that I think there are a lot of other factors connected with it, from our competitiveness, from the Third World debt problems, clearly the overvalued dollar was an important part of it, a very important part.

Senator PACKWOOD. If what you are saying is there are a lot of other factors, I am inclined to agree. I sometimes think that to single out solely the national debt as the predominant problem flies in the face of the experience in Germany and Japan which, with bigger per capita annual deficits than we do, run very significant trade surpluses. So, if there is a connection, it does not seem to be a uniform connection throughout the world.

Let's talk about Germany and Japan. I understand that you do not want them to take more imports. But as I understand you and the Secretary and the President, you want Germany and Japan to be less export-driven and to drive their economies more by domestic demand.

Mr. MCPHERSON. That is correct.

Senator PACKWOOD. How do you want them to go about achieving that?

Mr. MCPHERSON. There was a report of a senior Japanese official here, a year and a half ago or so, that laid out all this in a way that we thought was very impressive. In effect it asked for a deregulation of their society, everything from land use laws to their financial structure.

It is not a simple process, but while the Japanese per capita income approaches ours, what they can really get out of it is substantially less. And their rules and regulations and approaches need to be changed in such a way that——

Senator PACKWOOD. Now, wait a minute. You lost me there. I heard what you said, but I don't understand what it means.

Mr. MCPHERSON. For example, there are no property taxes—or at least that is argued, and I am sure it is a complex matter—but no property taxes on a vast amount of real estate. So, the relative use and value of property isn't reflected in the actual use.

Senator PACKWOOD. You mean you want them to have taxes on real estate?

Mr. MCPHERSON. Yes.

Senator PACKWOOD. All right.

Mr. MCPHERSON. And I believe—just to go into several things that are deep—there are several layers of middlemen which end up biting away at what the consumer will have. In many ways, it is interesting that what we are arguing—the prices of rice are way, way over market level—in many ways what the report argued was substantially along the lines of what some of the labor union people in Japan have been arguing. The consumers in Japan, we believe, need to be able to receive more—more for what they have; and when they do that, the domestic consumption will go up.

Senator PACKWOOD.You are not suggesting that they have tax increases or decreases?

Mr. MCPHERSON. No.

Senator PACKWOOD.You are not suggesting that they attempt to spur their domestic demand by widening their deficits which are already very significant?

Mr. MCPHERSON. No. In an immediate sense, we believe they ought to spend the 5 trillion yen or $35 billion that they have indicated, and we want them to spend it fairly quickly.

Senator PACKWOOD. On domestic issues?

Mr. MCPHERSON. Yes.

Senator PACKWOOD. You want the government to spend it, which will widen their deficit?

Mr. MCPHERSON. Which will widen their deficit. Their deficits are down somewhere where they were a couple of years ago; but that has to be viewed, in my judgment, as a short-term measure, Senator. The longer term have to be the more fundamental structure changes within their economies, and I believe it is really critical—not just modest matter, but a critical matter.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Mr. McPherson, Senator Chafee raised the question of superconductivity. The Washington Post carried a story yesterday morning about the Japanese organizing in this field and the United States sort of going at it with individual firms but with no concert of effort. This is kind of an interesting parallel that has been raised over the years, between the British experience and ours; and this matter of superconductivity is entirely American.

A professor from Alabama, I believe, gave the first paper on this. IBM has a lab in Switzerland that wrote the second. Last March, the American Physical Society had a meeting in New York which went from 9:00 in the morning until 3:00 in the morning, at which papers were given a maximum length of 10 minutes. And they are breaking through at this moment; they are not quite sure what the physics of it is, but they know that it works. Up at Alfred University in New York, which has about a third of the ceramics graduates in the country coming out of there, they know it. Yet, are we going to turn it into great economics? The British have done great physics and chemistry and whatnot, and they have seen other people dominate the manufacturing.

There is the issue of antitrust laws, is there not? Is there any inquiry going on in Treasury about that, or is that something that has to be done at Justice? There are worse things than an interdepartmental committee, from time to time, to discuss issues.

Mr. MCPHERSON. I think this was a matter focused on by the Economic Policy Council at the time that the President was putting together a competitiveness package.

Senator MOYNIHAN. Yes.

Mr. MCPHERSON. I don't remember the specifics of what was proposed there, but I know it was considered.

Senator MOYNIHAN. Would it be tedious to ask you, if I were to submit a question in writing, that you might give us an answer to that?

Mr. MCPHERSON. Sure.

Senator MOYNIHAN. And any thoughts you might have on it because it is clear. This is a preautomobile statute we work with.

Mr. MCPHERSON. It may be helpful for me just to tell you what I think the role of technology is in economic growth.

Senator MOYNIHAN. Yes.

Mr. MCPHERSON. I believe that the technology—particularly the computer and other related or nonrelated developments—during, before and after World War II really drove us for decades. And I believe it is critical——

Senator MOYNIHAN. We invented the computer as well.

Mr. MCPHERSON. Precisely. And we clearly wouldn't have civilization at the present technological level if we hadn't had the computer. And I believe that it is very important to focus on key things like new materials, like the superconductor, the basic technological developments, and how——

Senator MOYNIHAN. The transistor, the computer, fiberoptics.

Mr. MCPHERSON. And these are being used very effectively these days in the world economy.

Senator MOYNIHAN. Fiberoptics was developed, and the first paper was given in Corning, New York in 1972. It is that recent.

Mr. MCPHERSON. I am not for some sort of industrial policy; I really don't believe in that, but I do believe that we have to understand the role that regulation plays or doesn't play in developments like the superconductor.

Senator MOYNIHAN. And there are certain kinds of regulation that were established in the age of steam that really don't work perhaps in the age of superconductivity, or the age of electricity taken to a new power.

Mr. MCPHERSON. Sure. They don't work, as Senator Chafee was suggesting, in a world economy.

Senator MOYNIHAN. A world economy, yes.

Mr. MCPHERSON. That no longer has these nice, neat little national——

Senator MOYNIHAN. I thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Are there other comments?

[No response.]

The CHAIRMAN. Mr. McPherson, we are pleased to have you this morning, and we will be looking at your nomination at a later date.

Mr. MCPHERSON. Thank you, Senator.

[Whereupon, at 11:30 a.m., the meeting was concluded.]

[The prepared questions from Senator Wallop and Mr. McPherson's answers follow:]

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON D C 20523

THE ADMINISTRATOR

May 25, 1987

Dear Senator Wallop:

You have asked whether AID programs have adequately emphasized the private sector. I would like to review this area as a supplement to my responses to your written questions.

The principal development focus of AID is to foster economic growth and jobs. I have looked long and hard at the question of how best to perform this function. Early on at AID, I spent an hour with Walter Wriston, then CEO at CitiBank. He said, "Peter, don't kid yourself. There is not a general shortage of capital in the Third World. There is a great shortage of investments that can make money."

Based upon this conversation and other investigations, I concluded we should not make massive transfers and subsidies to the private sector anymore than we should give them to anyone else. Such private sector activity simply is not self-sustaining. AID should not be an international SBA.

What I have tried to do is to help create the basic conditions in which an investor can make money. Those basic conditions generally include sound economic policies, potential workers who are more or less educated and trained, a decent transportation and communication infrastructure, and the availability of pertinent technology. These basic conditions are generally available in the U.S. but not in the developing countries. This is the reason why there are so few investments that will make money in the Third World. Accordingly, I have focused a substantial portion of resources on achieving policy changes, training and educating, R&D for the Third World, infrastructure in a few countries like Grenada, etc.

I believe that this allocation of resources has done more for sustained growth and the private sector than would any other approach. More work with the private sector can be done but AID should not lose sight of the basic conditions required by investors in LDCs.

Perhaps most important in our effort has been the work on policy reform. Accordingly, let me go into that in some detail.

AID has played a significant role in the liberalization of exchange regimes in Bolivia, Costa Rica, Dominican Republic, Ecudaor, El Salvador, Jamaica, Somalia, Sudan and Zaire. Such liberalizations involve devaluation of the exchange rate, eliminating restrictions on foreign exchange access, eliminating implicit subsidies to government corporations through access to preferential exchange rates, eliminating restrictive import and export licensing, and eliminating implicit taxes on exports through overvalued exchange rates.

In addition, AID has sought to eliminate market distortions such as price, wage, distribution, and production controls; subsidized interest rates; and credit allocations. Our efforts have contributed to the reduction of economic controls and minimized the effect of these market distortions upon savings and investment in Bangladesh, Gambia, Ghana, Indonesia, Jamaica, Liberia, Madagascar, Mauritius, Malawi, Panama, the Philippines, Rwanda, Sri Lanka, and the Sudan.

AID's work on privatization is an ambitious program that combines the divestiture of state enterprises with adoption of market policies. This effort was given impetus at the International Conference on Privatization that we sponsored in February 1986. At that time we set an Agency target that most of our Missions be involved in an average of two privatizations annually. As a result, privatization has become a significant part of AID's private enterprise initiative.

Similarly, we have made tax reform an integral part of our policy dialogue with LDCs. For example, the tax reform legislation currently being implemented in Jamaica and Grenada, which reduced high marginal tax rates and removed disincentives to productive investment, is based upon extensive work supported by AID.

Tax reform supportive of private sector development is an important feature of our program in Senegal. We are also financing studies of fundamental tax reform in LDCs, including work by Alvin Rabushka of the Hoover Institute on the role of tax policy in economic growth.

I hope this is helpful to you. I would very much enjoy talking with you about our program here at AID.

Sincerely,

M. Peter McPherson

Honorable Malcolm Wallop
United States Senator
Washington, D.C. 20510

QUESTION:

A.I.D. officials have been implicated in the bribery of government officials in Ecuador. What investigations are occurring by A.I.D. to reveal the full extent of such bribery? What evidence have you collected to date on this problem? What specific steps have you taken to prevent it recurrence?

ANSWER:

There have been a series of management problems within the Ecuador USAID Mission, especially in the area of financial management. None of these problems has involved bribery of government official in Ecuador. Resolution of the problems in Ecuador has required replacement of Mission leadership and major changes in the Mission's financial management practices.

Problems which came to light included a substantial number of improper salary supplements for Government official of Ecuador. The intent was to help attract quality people to the Ecuadoran Government. The decision to provide these salary supplements was made in the USAID Mission without Washington knowledge or approval. As soon as the facts were known in October 1986, the Latin American Bureau management in Washington took decisive steps to halt A.I.D. participation in the salary supplements.

Further financial management problems included: overly broad use of Project Developement and Support Funds (PD&S); a large volume of outstanding advances; accounting records not kept in accord with A.I.D regulations; and, not withholding income taxes from Personal Services Contractors.

Based on information developed to date, many important measures have been taken by the Mission, the Bureau and the Agency to correct the deficiencies and strengthen Mission management. These include:

-- Making a series of personnel actions including replacement of the Ecuador Mission Director, Deputy Director, Controller, and Loan Officer plus adding new staff to strengthen USAID/Ecuador's management;

-- Issuing criteria and guidelines, dramatically limiting when A.I.D. can provide salary supplements (e.g., for a high-level critical technical staff person not otherwise available as opposed to high-level policy makers, etc.);

-- Instituting a systematic review of all Mission controller operations world-wide;

-- Issuing interim LAC Bureau instructions which strictly define and limit the use of PD&S funds;

-- Reducing project advances;

-- Implementing a series of accounting corrections to bring the Ecuador Mission's bookkeeping records into accord with A.I.D. regulations (LAC will bring in an accounting firm for an independent review of the adequacy of these Mission actions.); and

-- Ensuring proper Mission income tax withholding.

Since January 1987, the A.I.D. Inspector General has carried out an extensive investigation into all areas of Mission management. The IG has now issued a series of five draft Reports of Audit Findings. A.I.D. has initiated corrective actions on management and financial problems as these have been identified, both before and during the investigation. The Mission review and the Inspector General's investigation are still underway.

Great effort has gone into this comprehensive set of actions which we believe will correct the financial weaknesses found in Ecuador and also provide increased insurance against similar problems occurring elsewhere.

0723A

QUESTION:

Less than five percent of A.I.D. funds go directly to the private sector. Peter McPherson has publicly stated on numerous occasions that A.I.D. has redirected its emphasis to promote the private sector. Why has the reality differed so greatly from the rhetoric?

ANSWER:

Please see the cover letter that describes my approach in this matter.

QUESTION

Less than one percent of AID's expenditures in Grenada have gone to the private sector. Why hasn't AID done more to promote private markets in a nation that the Administration has so proudly used as an example of its successful foreign policy.

ANSWER:

A.I.D.'s intention from the beginning has been to promote private sector based growth in Grenada. In fact, the vast majority of our assistance has been designed to contribute to an overall policy, institutional and physical environment conducive to private sector investment and growth.

For example, most private sector development required first rebuilding key infrastructure facilities such as roads, electrical systems, potable water and factory shells. Completion of the Point Salines International Airport was important for development of tourism and industry, and President Reagan took a great interest it its completion.

The U.S. and Grenada private sector told us again and again that infrastructure is what they needed before they could invest. "How can we invest in a new plant if we don't even know if the lights will stay on," they said. This infrastructure

investment was, in fact, the right decision because only upon the substantial completion of the infrastructure has investment really begun to come back to the country.

We did some innovative work with the private sector. For example, A.I.D assisted revitalization of the private agricultural sector, provided technical promotion assistance through a contractor (Cooper-Lybrand) to facilitate U.S. and other foreign investment, and supported establishment of a private development foundation to assist small local entrepreneurs. This was not a large amount of money and I am firmly against a lot of money going for, in effect, subsidized loans to the private sector. If you need vast amounts of subsidies for the private sector, something is wrong with the local economic policy, physical infrastructure, quality of trained people, etc.

We also provided money for budget support for the Government of Grenada. It is easy to say that we should not have done so. However, it looks differently when the Prime Minister, whose country the U.S. has saved, appeals to the President of the United States, Secretary of State and A.I.D Administrator and says he needs budget support for his Government to survive. We provided and continue to provide some budget support because the country is a friend and also

because we have given the help in connection with their Government making certain policy changes. For example, we urged that taxes be cut, government expenditures be reduced and market forces be given a greater role. Steps in all these areas have been taken though more needs to be done. In short, I think our budget support has brought about very important changes for the private sector.

We also spent A.I.D. money on rebuilding a mental institution destroyed in the invasion and for a health system for the country. (Project HOPE has been the contract for the health system's work.) These expenditures were considered a political imperative.

0713A

QUESTION:

As part of the Administration that gave tax cuts a high priority, why has AID pushed aid recipients to increase taxes, such as has occurred, for example, with Niger, Zaire, the Gambia and Guinea-Bissau?

ANSWER:

A.I.D.'s policy is to encourage tax reductions. Attached is my directive to the field. We, for example, played an important role in encouraging such reductions in Jamaica and Gambia.

Also, I believe that taxes ought to be defined broadly to include all government burdens on production and earnings. That broad definition has meant that I have worked on reducing taxes in their usual sense, and that I have also worked hard to lift price controls on, for example, farmgate prices in Africa. In many African countries, price controls have held down prices to farmers at or below production costs with the result that per capita food production has been going down for many years. There is no question that A.I.D. has had a major role in getting many countries to allow their farmers to receive more for what they produce. Such price controls were in effect the taxes that urban dwellers in these countries

imposed upon the farmers. Our efforts to lift price controls have contributed to higher yields in 1986 in a number of African countries.

There are a couple of areas where confusion on this issue has arisen. Frequently, we have urged governments to increase the charges for electricity, water, etc., so that the cost for these public services would realistically reflect the cost of the service rendered. Governments often strongly resist on such increases because of the political impact and talk about such increases as "rising taxes". I've had discussions on this issues with leaders all over the world. I don't think these increases are taxes at all. I believe strongly that prices for public services to the extent possible should reflect their cost so that there will be a rational allocation of resources.

Another area of possible confusion is that A.I.D. provides some countries assistance to improve their administration of taxes, e.g., reduce corruption and evasion, greater efficiency, etc. This is very different than supporting higher rates, but nevertheless, we have become careful about what type of taxes we try to "make more efficient."

Also, I generally have supported the IMF because I could not see any other way for many countries to restructure their economies and attract additional resources. This has been an important contribution of A.I.D. these last few years, but it sometimes has gotten us close to some policies we did not fully support, especially the first couple of years of this Administration. A.I.D. and other offices in the U.S. Government talked to the IMF about the problem of tax increases in connection with IMF agreements. I think the IMF is a great deal more sensitive in the last couple of years about the issue of whether to raise taxes or cut budget outlays in connection with IMF agreements.

On the countries mentioned in the question, the USAID program for Guinea-Bissau does not include a tax project, has not funded any studies of the tax system, and no component of the program is devoted to taxation. We are supporting the country's ongoing structural adjustment efforts, including negotiations with the Fund for a new stand-by arrangement. One component of the Fund program calls for reductions in government spending, including the dismissal of employees.

A.I.D. has not encourage tax increases in Niger. In fact, the tax revenues are coming down in Niger -- revenues are lower now than they were in 1981 -- and the country is lowering, rather than hiking, tax rates. Only recently, the value-added tax and customs tariffs were reduced roughly 30 percent.

In the Gambia under our Economic and Financial Analysis project, a study of the tax system is being funded. Also, USAID has been involved in improving the collection machinery at customs; through a reorganization of personnel, fraud is being reduced. It is true that the Gambia has hiked the overall import tax from four to six percent and specific duties have been raised. However, A.I.D. played no role in pushing the increases. As part of a comprehensive IMF-supported reform program, the tax increases represented one element of a package of measures designed to reduce the country's massive budget deficits.

In Zaire, we have been pushing for reform of the tax structure and improved management of the tax system. More specifically, we have been active in rationalizing the tariff structure which, by and large, has resulted in a reduction, rather than increases, in tariff rates.

0717A

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E.O. 12356: N/A
TAGS:
SUBJECT: TAX PRINCIPLES FOR LDCS

1. DRAWING ON THE TAX CONFERENCE OF LEADING EXPERTS IN THE FIELD OF TAXATION AND ECONOMIC DEVELOPMENT THAT WAS HELD IN WASHINGTON ON OCTOBER 2-3 TO EXAMINE THE PRELIMINARY VERSION OF THE STUDY UNDERTAKEN BY RABUSHKA AND BARTLETT ON "TAX POLICY AND ECONOMIC GROWTH IN DEVELOPING NATIONS," AND ON OTHER WELL-KNOWN STUDIES IN CURRENT LITERATURE, PPC/EA PREPARED A BRIEF PAPER OUTLINING THE BASIC CONCLUSIONS AND PRINCIPLES THAT ARE STRESSED BY MOST EXPERTS IN THE FIELD. THE FOCUS OF THESE OBSERVATIONS BEAR ON THE INTERRELATIONSHIP BETWEEN TAXATION AND GROWTH. THE SUMMARY IS AS FOLLOWS:

A. TAX STRUCTURES IN DEVELOPING COUNTRIES ARE OFTEN MADE UP OF A PATCHWORK OF LEVIES INHERITED FROM THE PAST, SOMETIMES EVEN DATING BACK TO EARLIER COLONIAL REGIMES, ENACTED TO OBTAIN NEEDED REVENUES OR TO ACHIEVE OTHER OBJECTIVES AT VARIOUS POINTS IN TIME. THE INDIVIDUAL MEASURES FREQUENTLY ARE UNRELATED TO ONE ANOTHER OR TO CURRENT NATIONAL OBJECTIVES. OFTEN SUCH TAX STRUCTURES DO NOT ADEQUATELY REFLECT THE NEEDS TO FACILITATE OR

STIMULATE ECONOMIC GROWTH AND TO ALLOCATE RESOURCES EFFICIENTLY.

B. ALTHOUGH GOVERNMENTS ARE OFTEN WELL AWARE OF DEFICIENCIES IN THEIR TAX STRUCTURES AND OTHER ASPECTS OF THEIR PUBLIC REVENUE SYSTEMS, THEY ARE NOT ALWAYS PREPARED TO ADDRESS THE ISSUES BECAUSE OF THE POLITICAL PROBLEMS ASSOCIATED WITH ANY MAJOR REFORM EFFORT. NEVERTHELESS, IF A COUNTRY'S POLICY IS 100% OR JILL BE DIRECTED TOWARDS GREATER EMPHASIS ON PRIVATE SECTOR AND MARKET ORIENTED DEVELOPMENT, IT IS IMPORTANT THAT THE TAX STRUCTURE AS WELL AS OTHER ASPECTS OF THE SYSTEM BE SUPPORTIVE OF WELL FUNCTIONING MARKETS AND THE PRIVATE SECTOR'S ROLE. EVEN IF THE GOVERNMENT DOES NOT INTEND TO ENGAGED FOR THE PRIVATE SECTOR, IT WILL, AND IS IMPORTANT TO CONSIDER HOW THE STRUCTURE OF TAXATION TO RAISE NEEDED REVENUE AND OBTAINED AT MINIMUM COSTS TO EFFICIENCY AND GROWTH.

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C. UNFORTUNATELY, THEORY AND EXPERIENCE IN DEVELOPING COUNTRIES PROVIDE ONLY LIMITED ANSWERS TO MANY QUESTIONS ABOUT THE ACTUAL EFFECTS OF TAXES ON PRODUCTION, SAVINGS AND INVESTMENT. NEVERTHELESS, IT IS CLEAR THAT ILL CONCEIVED TAXES ARE AMONG THE FACTORS THAT CAN PLAY A ROLE IN DISCOURAGING GROWTH AND DEVELOPMENT THROUGH NEGATIVE INCENTIVE EFFECTS. HIGH MARGINAL INCOME TAX RATES APPLIED AT RELATIVELY LOW THRESHOLDS HAVE BEEN NOTED IN THIS CONNECTION. TAX SYSTEMS MAY SOMETIMES INCLUDE INCENTIVES DESIGNED TO STIMULATE SPECIFIC DEVELOPMENT ACTIVITIES, I.E., TAX HOLIDAYS TO SPUR THE DEVELOPMENT OF SERIOUSLY LAGGING REGIONS. IN MANY SITUATIONS, HOWEVER, OTHER CIRCUMSTANCES IN THESE CASES ARE SO NEGATIVE THAT THEY MORE THAN OFFSET THE POSITIVE EFFECT, RENDERING THE INCENTIVE INEFFECTIVE. THUS, CARE SHOULD BE EXERCIZED BEFORE RELYING SOLEY ON TAX INCENTIVES TO ACHIEVE THESE PURPOSES; THEY MAY NOT BE COST EFFECTIVE.

D. LDCS TYPICALLY RELY MORE HEAVILY ON INDIRECT THAN DIRECT TAXATION, PARTICULARLY TAXES ON FOREIGN TRADE. MANY DEVELOPING COUNTRIES DERIVE A SIGNIFICANT PORTION OF THEIR REVENUES FROM TAXES ON EXPORTS AND IMPORTS. IN MANY LDCS THE STRUCTURE OF TAXES ON FOREIGN TRADE HAS BEEN FOUND TO DISCOURAGE THE COUNTRY'S COMPARATIVE ADVANTAGE EXPORTS AND TO ENCOURAGE PRODUCTION OF IMPORT COMPETING GOODS AT A HIGH COST TO THE ECONOMY. SUCH TAX STRUCTURES PROMOTE INEFFICIENT RESOURCE ALLOCATION IN THE ECONOMY.

E. OTHER INDIRECT TAXES MAY ALSO INHIBIT COMPARATIVE ADVANTAGE PRODUCTION OR THE DEVELOPMENT OF FINANCIAL MARKETS, OR THEY MAY BE NUISANCE LEVIES WHOSE COSTS OF COLLECTION ARE HARDLY WARRANTED BY THE AMOUNT OF REVENUE OBTAINED. ANY SET OF ILL CONCEIVED INDIRECT TAXES CAN LEAD TO SIGNIFICANT DISTORTIONS IN PRODUCTION AND CONSUMPTION DECISIONS, AND THIS ASPECT OF THE SYSTEM SHOULD BE CAREFULLY REVIEWED, PARTICULARLY IN THE CONTEXT OF CONSIDERING REFORMS TO IMPROVE THE FUNCTIONING OF FREE MARKETS.

F. DIRECT TAXES ON INDIVIDUALS AND BUSINESS COMBINED DO SOMETIMES CONSTITUTE AN IMPORTANT SOURCE OF REVENUES IN LDCS. PERSONAL INCOME TAXES ALONE TEND TO BE LESS IMPORTANT, ALTHOUGH THESE SOMETIMES DO INCLUDE A HIGHLY PROGRESSIVE RATE SCHEDULE WITH VIRTUALLY CONFISCATORY TOP BRACKET RATES. SUCH EXTREME PROGRESSIVITY IS RARELY ENFORCED. WHEN IT IS NOT, IT COMPROMISES THE GOVERNMENT'S INTEGRITY. WHEN IT IS, IT DISCOURAGES DEVELOPMENTAL INITIATIVE. AND, FREQUENTLY, IT IS ENFORCED NON-UNIFORMLY (E.G., ONLY AGAINST FOREIGN HELD ENTERPRISES OR ENTERPRISES IN POLITICAL DISFAVOR). WHEN INFLATION HAS PERSISTED FOR SOME TIME AND WHEN INITIALLY REASONABLE TAX BRACKETS ARE NOT ADJUSTED OR ARE ADJUSTED ONLY TARDILY, HIGH MARGINAL RATES MAY APPLY AT LOW OR MODERATE LEVELS OF INCOME, IMPOSING AN UNDUE TAX LIABILITY ON LOWER INCOME GROUPS. IN SUCH CASES THE TAXES ARE RARELY COLLECTED AT THE PRESCRIBED RATES, BUT THE INCENTIVE SYSTEM IS BIASED AGAINST GROWTH, AND TAX REVENUE SYSTEM LOSES ANY INTEGRITY IT MIGHT HAVE HAD. TREATMENT OF BUSINESS INCOME RAISES PARTICULARLY DIFFICULT AND IMPORTANT ISSUES BECAUSE THE IMPACT OF THE TAX STRUCTURE CAN VARY SIGNIFICANTLY DEPENDING NOT ONLY ON THE TREATMENT OF ITEMS SUCH AS DEPRECIATION, INVENTORIES AND INTEREST PAYMENTS, BUT ALSO, ON HOW THE RULES ARE RELATED TO THE RATE OF INFLATION.

G. WHATEVER THE STRUCTURE OF TAXATION IN A COUNTRY THE IMPACT ON THE ECONOMY AND THE AMOUNT COLLECTED ARE OBVIOUSLY DEPENDENT ON HOW THE TAXES ARE ADMINISTERED. MOST LDCS SUFFER FROM VERY LIMITED ADMINISTRATIVE CAPACITY (AID, INTERNATIONAL ADMINISTRATION OF A FLEXIBLE TAX

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SYSTEM USUALLY IS NOT A PRODUCTIVE ACTION. BUT WHEN A COUNTRY UNDERTAKES TO REFORM ITS TAX STRUCTURE IT IS EQUALLY IMPORTANT TO COUPLE THIS WITH SPECIFIC IMPROVEMENTS IN ADMINISTRATION TO ASSURE THE REFORMS SERVE THEIR INTENDED PURPOSE. ADMINISTRATIVE IMPROVEMENTS MAY REQUIRE TRAINING OF TAX OFFICIALS AND INCLUDE, E.G., MOVEMENT TO SELF ASSESSMENTS, AUTOMATION OF INFORMATION, SIMPLIFICATION OF FORMS AND OTHER PROCEDURAL CHANGES, IMPROVEMENTS IN INVESTIGATIVE AND APPEALS PROCEDURES, AS WELL AS OTHER CHANGES IN THE LEGAL AND JUDICIAL HANDLING OF TAX MATTERS.

TAX ADMINISTRATION IS A COMPLEX ENTERPRISE, BUT ONE THAT CANNOT BE IGNORED IN THE CONSTRUCTION OF AN IMPROVED TAX SYSTEM.

6. MOST LDC GOVERNMENTS TODAY MUST DEAL WITH LARGE AND SOMETIMES GROWING BUDGET DEFICITS THAT CONTRIBUTE IMPORTANTLY TO INFLATION AND BALANCE OF PAYMENTS DEFICITS. SUCH MACROECONOMIC DISEQUILIBRIA CAN HAVE, PROFOUNDLY NEGATIVE CONSEQUENCES FOR GROWTH. THEREFORE, STABILIZATION MEASURES ARE AN ESSENTIAL INGREDIENT OF REFORM POLICIES. GOVERNMENTS NEED TO FACE THE NEED TO CUT EXPENDITURES--TO REDUCE OR ELIMINATE SUBSIDIES TO PARASTATALS AND FOR OTHER PURPOSES, TO CUT BACK BLOATED PUBLIC PAYROLLS AND TO ELIMINATE OR REDUCE ALL NONESSENTIAL EXPENDITURES. SUCH ACTIONS ARE TYPICALLY DIFFICULT AND PAINFUL, AND, UNDERSTANDABLY, IN THESE CIRCUMSTANCES, LDC GOVERNMENTS MAY BE RELUCTANT TO UNDERTAKE TAX REFORMS THEY BELIEVE WILL HAVE AN ADVERSE EFFECT ON REVENUES OR INVITE TROUBLESOME OR UNMANAGEABLE POLITICAL OPPOSITION. NEVERTHELESS, CRITICAL OBJECTIVES OF TAX REFORM EFFORTS SUPPORTED BY A.I.D. ARE TO PROMOTE ECONOMIC GROWTH AND WELL FUNCTIONING MARKETS.

7. IN MOST LDCS THESE TAX REFORM OBJECTIVES CANNOT BE ATTAINED THROUGH CHANGES IN THE TAX SYSTEM ALONE. THEY ALSO REQUIRE REFORM OF OTHER POLICIES THAT AFFECT DECISIONS ON SAVING, INVESTMENT, RISK TAKING, WORK EFFORT AND OTHER RESOURCE ALLOCATION DECISIONS. CANDIDATES FOR REFORM INCLUDE, FOR EXAMPLE, SUCH POLICIES AS: BELOW MARKET INTEREST RATE POLICIES; OVERVALUED EXCHANGE RATES; PRICE CONTROLS AND POLICY-BASED RIGIDITIES IN LABOR MARKETS. EVEN MAJOR TAX REFORMS MAY FAIL TO HAVE A SIGNIFICANT IMPACT ON THE DEVELOPMENT CLIMATE IF OTHER DISTORTING POLICIES OF THIS KIND ARE NOT CORRECTED.

8. TAX REFORMS CANNOT BE IMPORTED READY MADE; THERE ARE FEW IF ANY SOLUTIONS APPLICABLE TO ALL COUNTRIES. HOWEVER, THERE ARE A NUMBER OF GENERALIZATIONS THAT ARE LIKELY TO HAVE VALIDITY FOR MOST LDC TAX SYSTEMS:

- THE TAX STRUCTURE SHOULD BE AS SIMPLE AS POSSIBLE. IT IS BETTER TO RELY ON A FEW BROADLY BASED TAXES THAN A LARGE NUMBER OF UNRELATED LEVIES.

- THE TAX STRUCTURE SHOULD BE CONSISTENT WITH THE ABILITY OF THE COUNTRY TO ADMINISTER THE SYSTEM EFFECTIVELY.

- BALANCE SHOULD BE SOUGHT BETWEEN DIRECT AND INDIRECT TAXATION.
HIGHLY PROGRESSIVE PERSONAL INCOME TAXES ARE RARELY FULLY COLLECTED BUT THEY OFTEN STILL HAVE AN IMPACT ON PERSONAL INVESTMENT AND PRODUCTION DECISIONS. THAT EFFECT ON GROWTH IS CLEARLY NEGATIVE. THEY ALSO CREATE OTHER PROBLEMS AND SHOULD BE ELIMINATED. CONSIDERATION SHOULD ALSO BE GIVEN TO INDEXATION FOR INFLATION TO AVOID "BRACKET CREEP."

- SPECIFIC INCOME TAXES ARE BEST LEVIED AT MODERATE RATES, WITH EXEMPTIONS FOR LOWER INCOMES, A MINIMUM OF ALLOWABLE

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DEDUCTIONS AND THE APPLICATION OF WITHHOLDING WHERE FEASIBLE.

- TAXES ON BUSINESS INCOME SHOULD BE AT MODERATE RATES TO AVOID DISINCENTIVES TO GROWTH PRODUCING ECONOMIC ACTIONS.

- SPECIAL BUSINESS EXEMPTIONS TO ACHIEVE A PARTICULAR PURPOSE SUCH AS TO EXPAND "NON-TRADITIONAL" EXPORTS SHOULD BE USED WITH GREAT CARE, TO AVOID A LONG TERM SUBSIDY. MEASURES OF THIS KIND ARE LIKELY TO BE POOR SUBSTITUTES FOR OTHER REFORMS NEEDED TO IMPROVE THE INVESTMENT CLIMATE.

- TAXES ON FOREIGN TRADE SHOULD NOT INTERFERE UNDULY WITH COMPARATIVE ADVANTAGE. THIS MAY MEAN THAT A COUNTRY SHOULD STRIVE TO ACHIEVE A MORE UNIFORM SET OF IMPORT DUTIES AND TO ELIMINATE EXPORT TAXES.

- THE TAX SYSTEM SHOULD MAKE ITS MAXIMUM CONTRIBUTION TO GROWTH AND DEVELOPMENT RATHER THAN BE USED AS A TOOL TO BRING ABOUT SUBSTANTIAL INCOME DISTRIBUTION RESULTS.

- WHILE TAX REFORMS CAN BE UNDERTAKEN STEP BY STEP, THERE IS MERIT IN SYSTEMATICALLY ADDRESSING THE SYSTEM AS A WHOLE TO ASSURE THAT ITS VARIOUS COMPONENTS WORK HARMONIOUSLY TOWARDS DESIRED GOALS. THIS HAS APPLICATION TO TAX ADMINISTRATION AS WELL AS TO ECONOMIC IMPACT.

- OTHER POLICIES MAY REDUCE THE POTENTIAL ECONOMIC GROWTH STIMULUS OF TAX REFORM. THESE SHOULD BE IDENTIFIED AND FORM PART OF THE TAX REFORM POLICY DIALOGUE AGENDA.

9. AID/W WELCOMES ANY COMMENTS OR THOUGHTS MISSIONS MAY WANT TO OFFER WITH RESPECT TO THE CONCLUSIONS AND PRINCIPLES. SHULTZ

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08/01/85 632-8558
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MPM
KMK K
RAD
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E.O. 12356: N/A

TAGS:

SUBJECT: IMPACT OF HOST GOVERNMENT TAX STRUCTURE

FOR: MISSION DIRECTORS

ACTION FOR: SAN SALVADOR, GUATEMALA, TEGUCIGALPA, SAN JOSE, PANAMA, SANTO DOMINGO, KINGSTON, LIMA, MANILA, BANGKOK, ISLAMABAD, DHAKA, NEW DELHI, CAIRO, KHARTOUM, MOGADISHU, NAIROBI, MONROVIA

INFO TO ALL OTHER POSTS

REF: {A} STATE 171187 {B} STATE 190705

1. IT IS CLEAR THAT MORE ATTENTION SHOULD BE GIVEN TO THE ISSUE OF TAX REDUCTION IN MANY DEVELOPING COUNTRIES. AMONG OTHERS, THIS HAS BEEN RECOGNIZED BY THE GOVERNMENT OF JAMAICA, WHICH RECENTLY ISSUED A COMPREHENSIVE REPORT CALLING FOR FUNDAMENTAL REFORMS TO ADDRESS THE DISINCENTIVES CREATED BY HIGH MARGINAL INCOME TAX RATES AND TO RECTIFY OTHER ADVERSE FEATURES AFFECTING THE EFFICACY AND EFFICIENCY OF THE TAX SYSTEM.

2. I FIRMLY BELIEVE THAT THE ISSUES OF TAX REDUCTIONS INCLUDING BOTH STANDARD TAX POLICY AS WELL AS "HIDDEN TAXATION" RESULTING, E.G., FROM INFLATION, INAPPROPRIATE POLICIES OF MARKETING BOARDS MUST BE GIVEN HIGHER PRIORITY IN OUR POLICY DIALOGUE WITH MANY HOST COUNTRY GOVERNMENTS. I PLAN TO BROACH THESE ISSUES PERSONALLY IN CONTACTS WITH KEY HOST GOVERNMENT OFFICIALS. I ALSO EXPECT THESE ISSUES WILL BE ADDRESSED IN MISSION POLICY REFORM ANALYSES AND ACTION PLANS, AND I LOOK FORWARD TO DISCUSSING THEM WITH YOU.

3. INITIAL RESPONSES TO QUERIES IN REFTEL A. HAVE BEEN RECEIVED FROM ALL ACTION POSTS. REPLIES HAVE ALSO BEEN VOLUNTEERED BY SEVERAL INFO ADDRESSEES, FOR WHICH WE ARE MOST APPRECIATIVE. A FEW OF THESE MESSAGES CONTAIN SUBSTANTIAL AMOUNTS OF RELEVANT INFORMATION, BUT MANY POSTS HAVE FOUND IT DIFFICULT TO PROVIDE THE REQUESTED MATERIAL WITHIN THE TIME FRAME ESTABLISHED IN REFTEL B, I.E., BY JULY 20.

4. WE ARE CONSIDERING THE SUGGESTIONS AND PROPOSALS PUT FORWARD BY A NUMBER OF MISSIONS ON ALTERNATIVE MEANS TO ADDRESS THE QUESTIONS AND ISSUES RAISED. MEANWHILE, YOU SHOULD MAKE EVERY EFFORT TO PROVIDE AS MANY ANSWERS TO THE QUERIES AS POSSIBLE NLT AUGUST 20.

5. ALTHOUGH WE HAVE NOT YET REACHED A FINAL DETERMINATION AS TO HOW BEST TO PURSUE FIELD STUDIES OF THE TAX ISSUES TO FOLLOW UP YOUR RESPONSES, AT MY REQUEST, A STUDY BASED ON EXISTING MATERIALS IS BEING CARRIED OUT BY DR. ALVIN RABUSHKA OF THE HOOVER INSTITUTION AND OTHERS. THE TERMS OF REFERENCE, INTER ALIA, CALL FOR AN ANALYSIS OF THE RELATIONSHIP BETWEEN TAX POLICY AND INCENTIVES TO DETERMINE HOW TAX POLICY EITHER HAMPERS OR FOSTERS ECONOMIC EFFICIENCY. IT ALSO CALLS FOR A REVIEW OF SUCCESSFUL CASES OF TAX REFORM. THE DRAFT REPORT WILL BE CONSIDERED IN DEPTH DURING A TWO DAY SEMINAR BRINGING TOGETHER TAX AND DEVELOPMENT EXPERTS AND PRACTITIONERS. THIS WORK SHOULD BE COMPLETED BY OCTOBER 30. YY

QUESTION:

Why have U.S. funds been used to promote land reform program in El Salvador which has greatly diminished agricultural output?

ANSWER:

The land reform program was undertaken in El Salvador beginning in 1980 and A.I.D. began to work with the government on the program at that time. Its purpose was to deny the guerillas a key argument with the rural population.

The program has had many shortcomings, and I have been personally very interested in trying to reform the reform. I have been to the country many times over the six years I have headed A.I.D. and I have said again and again that the program has been very important in the fight against Communist, but, the Land Reform Cooperatives have not worked and there have been many other problems. In short, a political success but an economic failure.

Production on most PHASE I cooperatives has declined below the pre-reform period. This is largely due to the fact that many cooperatives are very much like state farms. However, production increases have occurred on Phase III land -to-the-tiller farms, which are plots individually owned and operated by small farmers.

Many times I have urged to the President of El Salvador to make reforms in the program. Specific, I have argued that all cooperatives should be real cooperatives, owned and managed by the members. None of them should be government-owned or de facto run by the government. I have further argued that cooperative members should also be able to farm plots individually within the cooperatives, and that farmers should be able to transfer their cooperative's shares.

I have told the President that I think the Phase III program should be changed as well. Specifically, I think that the small farmer should be able to sell his plot to another small farmer after a few years if he so choses. There are a number of other reforms that we have proposed. Some changes have been made over the years, but many other important ones have not been made.

0716A

QUESTION:

Why does A.I.D continue to support government-run agricultural marketing boards in many countries, for example, funding a project in Mali to increase the efficiency of its grain marketing boards.

ANSWER:

I think government-owned marketing boards are almost always a mistake and that has been my policy in A.I.D. We have worked all around the world on this the last few years and I doubt if there is hardly a professional employee at A.I.D. that does not clearly understand my view. Sometimes we have to work at it in phases and sometimes our political relationship with the country prevents us from being as hard-nosed as we would like, but our goal clearly is to reduce the role and when practical get rid of government-controlled marketing boards.

A.I.D. has worked all over Africa to cut back and phase out marketing boards. It's a tough job, given that those marketing boards were set up and supported for generations by the French and British colonial powers. These countries are accustomed to having the government perform certain marketing functions about like the U.S. public thinks of the mail as a U.S. Government function.

The Grain Marketing Board in Mali is an example of our efforts in Africa. Several years ago, the Malian Office for Agricultural Product Marketing (OPAM) was the only authorized grain trader in the country. Then, in connection with an A.I.D. project, private sector trade in course gain was legalized. In December of 1986, the Government of Mali announced the completely liberation of rice marketing and the first objective of our A.I.D. project -- marketing liberalization -- was achieved in theory. The private sector ability to handle the course grain market has been growing steadily, but its capacity to market rice is much less. Also, the private sector has not built up a capacity (neither financial or physical) to play a major role in inter-seasonal grain storage. Accordingly, A.I.D. is supporting and working to increase the private sector capacity to store and trade domestically-produced grain. This process will take some time. In short, we are helping OPAM phase out of its monopoly function and we are building the private sector to move in. This does involves some work with OPAM but I think our private sector goals are enhanced by doing so.

Similar type of initiatives are being supported as part of U.S. surplus food program in Gambia. The Government of Gambia, with our support, has already taken the important steps of

ending the Gambian product marketing board's (GPMB) domination of commercial rice imports and has opened the fertilizer trade to private merchants.

A number of other steps, to be taken over a period of time, have been agreed upon between the U.S. and the Gambian Government. This agreement is in connection with the U.S. providing the food. The food will be given to the Government of Gambia over a period of time and they in turn will sell it in their country. In effect, we are providing budget support to the Government as they make reforms.)

The next action of the Gambian reform process will be to sell off non-productive GPMB assets and thereafter to end GPMB's subsidization of public services. The next step in this process is to divest GPMB of peripheral operations so that they can concentrate on oil-feed marketing and processing, an activity for which GPMB believes it enjoys a comparative advantage. I believe this function too needs to be moved into private hands as soon as practical.

A.I.D., as can be seen from these examples, is working with government markets boards but not to build them up. Through well planned efforts, A.I.D. is working for an orderly

phase-down or breakup of these operations and their functions. This job is not easy. There are constant judgment calls, but our goals are clear.

0714A

Parastatal Marketing Boards

QUESTION: : Despite ennormous infusions from A.I.D. and Salvadoran Government agricultural development banks, production levels on the cooperative farms created by the program are lower than those of existing privately owned farms. Most of the cooperatives are in debt to the Salvadoran Agricultural Development Bank (BFA), borrowing heavily each year to cover costs that their harvests cannot support.

Reviews by A.I.D.'s Inspector-General (I-G) have repeatedly exposed the precarious financial condition and questionable activities of the BFA. A 1984 audit found that at the start of the reform program in 1980, the BFA, suffering from a severe liquidity crisis, used approximately $1.4 million in A.I.D. funds for unauthorized purposes. The audit further noted that while the BFA's financial viability depends upon the cooperatives servicing their debt, "most cooperatives are not financially viable operations and therefore don't generate sufficient revenues to pay their debts." A January 1987 audit found the BFA is operating at a loss and recommended that the BFA divest itself of its activities in the purchasing, storing and marketing of crops.

Why has A.I.D. supported this (BFA) marketing parastatal in El Salvador?

Answer: A.I.D. does not support parastatal marketing activities by the Agricultural Development Bank (BFA) in El Salvador. Our program in El Salvador has been limited to providing assistance for the credit operations of the Bank, including production and investment credit and activities designed to improve Bank efficiency (technical assistance in bank and portfolio management, credit analysis, collection procedures, and provision of equipment and vehicles).

My preference would be to use a private entity to provide credit to the politically important land reform system, but there is no option to do this in El Salvador at this time.

Parastatal marketing activities are actually carried out by a separate entity, the Salvadoran Regulatory Institute for Basic Grains (IRA). The IRA does not receive A.I.D. support. The 1987 audit report referred to questions the coordination of Bank's credit activities with procurement by IRA. In fact IRA actually buys at a higher price than private intermediaries, but transaction costs of selling to IRA are so high that farmers often prefer to sell through private channels. The BFA requires borrowers to sell to the IRA, to assure collection, but the IRA does not always have the resources to meet its obligations. Our Mission in El Salvador is working with the government to remedy this problem; we need a system that has less government involvement. This situation is a good example of why governments don't work very well when they try to carry out business functions.

0720A

QUESTION:

It is widely believed that a very large number of A.I.D contracts go to former A.I.D personnel, often due to a revolving door between A.I.D and the private voluntary organizations (PVOs). How many A.I.D. contracts have been given to former personnel under Peter McPherson tenure?

ANSWERS:

I have been sensitive to this issue and A.I.D. is very rigorously enforcing all laws and rules in this area.

A.I.D.'s relationship with some of its former employees is basically the same as other Federal Government agencies who implement a large portion of their work through contractors.

The revolving door is a government-wide issue. There is a tension between the need for expertise gained by working on specific government programs versus the possibility of over-reaching through old relationships and conflicts of interest. For now, the Federal Government has struck the balance with its complicated conflict of interest and related laws. As I indicated above A.I.D. is rigorously enforcing these laws.

A.I.D. does not maintain specific records on the employment of former employees and so we are unable to give you a number.

0715A

PVOs AND BRIBERY

Senator Wallop: PVOs use public monies to bribe local government officials to obtain their endorsement for proposed A.I.D. projects. Does A.I.D. condone this practice? Is it true that PVOs who engage in such activities continue to receive funding?

Answer: We know of no such instances where PVOs have bribed or been accused of bribing local government officials for endorsement of proposed A.I.D. projects. Of course, the Agency would not condone an illegal practice such as this and in the event that such a case should occur, we would immediately take appropriate legal action.

QUESTION:

Has A.I.D. used public money to create a lobby, the National Citizens Network, for its programs? If so, how much? Is this in violation of any federal law which restricts lobbying financed by federal money?

ANSWER:

A.I.D. provided $284,000 in FY 1986 to the Citizen's Network. No funding has been provided in 1987. The Network has raised about $200,000 of private money and additional pledges, exceeding that amount, are expected to be paid to the Network by the end of the calendar year.

The Citizen's Network is not a lobby. It is a non-profit, educational organization committed to educating Americans on foreign affairs programs. As such the Network has applied for and received a tax exempt status from the Internal Revenue Service. The organization strictly limits its activities to educational initiatives.

Moreover, A.I.D. carefully considered the activities of the Network before providing funds and took special efforts to see to it that no part of its contributions could be construed as contributing to any lobbying effort, which is, as you suggest, prohibited by Federal law.

0722A

Question::

Does A.I.D. fund a youth organization called "Spearhead" in Malawi? Is this organization Communist or Communist-allied, and if so, why does A.I.D. continue to fund it?

Answer:

A.I.D. made a loan of $2.5 million to Spearhead Enterprises Limited (SEL) in 1984 for the purpose of providing bridge financing to SEL as it attempted to divest (privatize) its agriculture holding to a group of private investors including two U.S. businessmen. SEL was unsuccessful in its privatization effort as of June 1986 and the A.I.D. loan was terminated and repaid in full. No additional funding has been provided to SEL.

Spearhead is neither a communist nor Communist-allied organization. It is a government entity which the government of Malawi, a staunchly anti-communist country, has been attempting to privatize for the past three to four years.

The organization now known as Spearhead originated in 1968 when the Malawi national youth movement, a government funded organization, undertook running a gasoline station. In subsequent years the youth movement with government funding established or acquired a series of agricultural and industrial businesses which by the late 1970s operated multiple businesses including over 20 tobacco estates; rice, tea, coffee, and

vegetable farms; a garment factory; a truck fleet; and so on, spread throughout the entire country. In 1975, all these businesses were grouped together as "Spearhead Enterprises" with a management structure separate from but associated with and providing funds to the youth movement.

In 1978 Spearhead was incorporated as Spearhead Enterprises Limited, a government owned company which apparently operated and traded on equal terms with private sector companies and was subject to the taxation applicable to private firms. Government Guarantees for Spearhead borrowings were also withdrawn.

QUESTION:

Proceeds from PL 480 sales are required to be deposited into a special account for PL 480 Title II transfers. Proceeds are released from such accounts upon A.I.D. concurrence, for local projects. In the Sudan, however, an audit report has revealed that funds generated from PL 480 sales were not deposited properly. For example, Burkina Faso, in 1985, failed to deposit about $1.1 million in local currency as required by the procedures set out by PL 480.

ANSWER:

For the most part, local currency proceeds generated under the U.S. foreign assistance programs are used to accelerate the economic development of the recipient country. The Sudan and Burkina Faso cases are unusual.

The Sudan case was complicated by several extenuating factors including a major drought in the country, a coup d'etat which led to the establishment of an interim government, and finally a newly elected government. These factors made it extraordinarily difficult to institute and monitor local currency monitoring procedures. As of May 1986 the Mission had established a system to monitor the deposits, programming, and utilization of all local currency generations, from the PL 480 program as well as other programs.

In the case of Burkina Faso, the Government has now deposited $1,283,000 of the $1,745,000 required under the Title II, Section 206 agreement. The most recent deposit into the special account was made in February 1987, and the Government was expected to deposit the balance within three months. The Government agreed to deposit the local currency into the special account in large part because the Mission was prepared to withhold the additional wheat shipments provided under the agreement. The Mission also conditioned future sales of U.S. donated Title II commodities on the Government making these deposits.

QUESTION:

It has been reported in the Washington Post and other newspapers that A.I.D.'s oral rehydration program has resulted in the deaths of a number of infants in Peru. This was caused by a fatally-flawed medication purchased by A.I.D. What has been the total number of infant deaths attributed to this error? What companies or individuals were negligible in this case? What kind of disciplinary action has been taken against those responsible? Has there been any extensive and systematic report written on this by A.I.D. or others?

ANSWER:

The question must be put in the context of my initiative of a greatly expanded A.I.D. effort with ORT. The biggest killer of children in the Third World is dehyration from diarrhea. Probably four million children die a year from this cause. A.I.D.'s efforts have been very successful with a much expanded use of ORT. Probably a million or more lives have already been saved, including many lives in Peru, and in time it will be many, many millions.

On May 22, 1986, the Director of U.S. Materials Company, the supplier of the oral rehydration salts to A.I.D. was indicted by a grand jury in White Plains, New York on 35 violations of Federal law as a result of an investigation initiated by A.I.D. in Peru and the United States. The grand jury believes that the Director of the company fraudulently misrepresented to A.I.D. the company's capability to perform the contract. He subsequently has been indicted for involuntary manslaughter as a result of the deaths of four

children who were treated with the salts at Cayetano Heredia Hospital in Lima. (There was a possible fifth death attributable to the salts but the evidence is not as clear.) Now that the matter is in the criminal justice system, A.I.D. has been requested not to comment on those aspects of the incident under investigation and litigation.

With regard to a systematic report, the Food and Drug Administration and the U.S. Attorney's Office have conducted extensive investigations and will use this information in the trial which will take place in New York in September of this year.

Since this unfortunate incident occurred, A.I.D has provided extensive guidance to all field posts which specifies explicit A.I.D. ORT procurement requirements to avoid any such future problems. Missions must now obtain A.I.D./Washington approval for any procurement of ORT made in the United States which is not made through the General Services Administration.

Oral rehydration therapy (ORT) is a proven medical technology which has been used worldwide for over 20 years. ORT is strongly endorsed by WHO, Pan America Health

Organization (PAHO), UNICEF and other international organizations as a proven treatment that saves the lives of million of children worldwide each year.

0726A

QUESTION:

AID funded the magazine Development International, which premiered in November, 1986. In its first issue the magazine profiled Ariel Dorfman, from the Institute for Policy Studies, who opines that "development has too often been defined as growth." Does Peter McPherson share this view? Does Peter McPherson believe that AID funds should be used to disseminate such a view? How much AID funds have been given to Development International? Is this magazine still being funded by AID?

ANSWER:

I do not agree that development has too often been defined as growth. Sound economic policy to encourage market forces and thereby growth has been the foundation of much of our work at A.I.D.

Although A.I.D. did provide funding to Development International, we ended our support subsequent to publication of the first issue.

0721A

QUESTION:

Why does so much assistance continue to flow to adversaries of the U.S., including Mozambique?

ANSWER:

The U.S. foreign aid program is very supportive of U.S. foreign policy. One of the first things I did as A.I.D. Administrator was to go to then-Secretary of State Haig and say to him that I wanted to report directly to him. Technically, I report to the President, but for day-by-day purposes, I thought it critical to have a close relationship with the Secretary of State. This relationship has been reflected in the way I have run this program. I have kept important humanitarian and developmental roles for A.I.D., but clearly A.I.D. is very sensitive to U.S. foreign policy interests, e.g., the Philippines, Central America, the Middle East, the Horn of Africa, Pakistan, etc.

As to Mozambique, the President and the Secretary of State have made a controversial but calculated decision to support the Government of Mozambique. That Government receives military support from the Soviets, votes against the U.S. in the UN, etc. However, they also liberalized their economic policy to an important degree, signed the Nkomati Accord, etc.

There are problems but substantial possibilities with this policy for a country that is likely to be so important to what happens in Southern Africa. A.I.D is an instrument that can be important in winning the gamble.

A.I.D.'s program to Mozambique has two basic components.

By far the largest ($75 million in 1987) is for emergency food aid relief. However, A.I.D. has provided emergency disaster assistance to numerous countries around the world. Our policy was stated by President Reagan on numerous occasions when he said, "That a hungry child knows no politics." This food probably would go to Mozambique regardless of our political relationship with Mozambique, just as we have provided a tremendous amount of food to the people of Ethiopia.

The second component of A.I.D.'s program is to help rehabilitate Mozambique's private sector. ($9.8 million in FY 1987)

0718A

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